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### The behavior of assurance professionals

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## 2. Auditors' Professional Behavior – A Conceptual Framework

### 2.1 Introduction

The assurance profession finds its fundamental behavioral principles in an extensive and stringent set of rules and standards. Nevertheless, the collapse of Arthur Andersen as a consequence of the Enron debacle and other financial fiascos have raised questions about the integrity of the accounting profession (e.g., Wyatt 2004; Sikka 2009b). Apparently, it is not clear what the profession actually means with these core behavioral principles. These principles are furthermore subject to a “continuing changing equilibrium” of stakeholders’ and the society’s expectations of the behavior of assurance professionals (e.g., Neale 1996).<sup>22</sup> Given the relevance of behavior in general and to the assurance profession in particular (see § 1.1), the research question central in this chapter is:

- What is professional behavior in general and that of auditors in particular, what drives professional behavior, and how does culture play a role in this context?

For these research questions, a literature review approach is taken resulting in an overview<sup>23</sup> of auditors’ professional behavior. This also forms the theoretical foundation for the empirical phase of this study.

To answer these questions, in § 2.2, I cover the fundamental theories on professional behavior in general and provide a definition of professional behavior for purposes of this study. The assurance profession is introduced in § 2.3, including its espoused values and behavioral research history. In § 2.4, the actual professional

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<sup>22</sup> A subtlety in the social norm is the “continuing changing equilibrium” of stakeholders’ and environment’s expectations of professional ethical behavior (Neale 1996: 220): “Professional misconduct is inevitable, given the [changing equilibrium], in which [societal] stresses give rise to the possibility that particular actions which may have been regarded as acceptable at one time need not always be seen in that light; professional conduct can become misconduct, and the reverse process is also possible”. Magala argues this to be one of the essences of culture (Magala 2009: 4): “Such and many other forms of recycling, re-branding and repackaging of values and ideas never stop, since this is what our culture is mostly about”. Neale concludes: “This process of disequilibrium and change leads to altered views of professional behavior” (1996: 219). The Enron-Andersen case and the loss of self-regulation induced such equilibrium changes.

<sup>23</sup> As with every overview or model, there are a number of inherent limitations to a conceptual framework. In this case; (a) I have focused my analysis on the behavior of a specific group, being formally recognized and employed professional auditors; (b) presenting the complexities of the “black box” of professional’s behavior in a more practical framework (which includes categorizations) and making things look clear-cut and simple “may mislead at best” (Alvesson 2002: 47) and may result in *oversimplified reality* and a loss of theoretical interpretative power; (c) one needs to be very careful to assume *causal relationships* between certain behaviors, the factors driving those behaviors and the outcome of the behaviors (being performance or action). This one-dimensional framework cannot reflect the complexity of *multifactorial causality* or *multiple interactions* among the constructs.

behaviors of auditors are illustrated as they are covered in this study. In § 2.5, I present a high-level conceptual framework for the systematic explanation of the professional behavior of auditors to put the potential effect of national culture on behavior to context and perspective. This theoretical overview is completed with a conclusion in § 2.6.

## 2.2 What is professional behavior?

To the best of my knowledge, there is no universally acknowledged or accepted definition of what professional behavior is. The first question to be answered, then, is what is actually meant by professional behavior. One might start by looking it up in the dictionary: “People’s or animals’ behavior is the way that they behave” (Collins Cobuild Dictionary). The definition of “behave” brings something of “action” into play: “The way that you behave is the way that you do and say things, and the things you do and say.” Also, management literature stresses “action” as a central aspect of behavior, for example:

- Behavior is human action which is oriented to the attainment of ends or goals or other anticipated states of affairs, takes place in situations, is normatively regulated, and involves expenditure of energy or efforts or “motivation” (Parsons and Shils 1951: 53).
- Behavior is any form of human action (Adler 2002: 18).
- Behavior is words and deeds (Hofstede 2001: 2).
- Behavior is action that is shaped by the desires (motivations), beliefs and opportunities of the agent (Elster 2007: 40, 163).
- Behavior is determined both by the cultural predisposition (the perceptions, thoughts, and feelings that are patterned) and by the situational contingencies that arise from the immediate external environment (Schein 2004: 19).

Looking at some fundamental theories of professional behavior in contemporary social sciences, one notices that these cover the inputs (e.g., desires and motivations, situational contingencies), an estimated intentionality (oriented to a certain value or outcome), the “mechanisms” by which behavior is shaped (e.g., the influence of the immediate environment, expenditure of efforts) and the outputs of behavior (e.g., action and deeds, attainment of end goals). For example, Parsons and Shils (1951) defined three levels of the “systems of orientation” that guide people’s actions and behaviors in their “General Theory of Action”:

- The personality system defines actions of an individual based on need-dispositions or personal motivation. Depending on the object being wanted or not and the value attached to it, “energy” will be allocated among specific goals and objects, i.e., *motivation* thus being the energy to be put in certain action and behavior.

- The social system defines the *interaction* process between two or more actors, in which the actors’ own “system of orientation” is interdependent with the other actors’ orientations, needs, motivations, and norms. In this social interaction, “role expectation” is a factor directing the behavior; *people behave within the role other actors in that society expect of each person in that society to play to maintain that society*.
- The cultural system describes the organization of the values, norms, and symbols which guide the choices made by actors and which limit the types of interaction that may occur among actors. These choices are guided by preferred choice alternatives or programming – a pattern of five choice-alternatives covered in Chapter 3 such as affectivity, self-orientation, and achievement).

Behavior, in Freud’s reasoning, is driven by personality traits and guided (or “repressed”) by boundary systems of the socially acceptable. In the “Freudian theory of the unconscious” (later termed as psychoanalysis), a dynamic explanation was developed to reflect the ongoing “interaction” between the “id”, “ego”, and “super-ego” within a single individual’s personality. To quote Magala’s review of Freud’s theory (2009: 54):

Individual personality developed between those two powerful masters [the authentic desire of the “id” and the symbolic internalized “controller” of one’s behavior, the “super-ego”] fighting for their share in determining behavior; unconscious desires propel the individual towards sexual fulfillment [and other true desires], internalized norms repress these desires in order to channel behavior into patterns acceptable to society. “Ego” deals with both, giving us a feeling of becoming ourselves, of acquiring a unique identity (...) Without internalized repression collaboration with others would be difficult. Without unconscious drives, there would be no emotional flavor and creativity in social life.

A more concrete framework that adds considerably to the understanding of professional behavior is Ajzen’s “*Theory of Planned Behavior*” (1988, 1991). In this conceptual behavioral framework, the central idea is that behavioral achievement depends jointly on motivation (*intention*) and ability (*behavioral control*).<sup>24</sup> The theory of planned behavior postulates three conceptually independent *determinants of intention* which are considered a function of salient *beliefs* relevant to the behavior:

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<sup>24</sup> Intentions would be expected to influence performance to the extent that the person has behavioral control, and performance should increase with behavioral control to the extent that the person is motivated to try. *Intentions* are assumed to capture the motivational factors that influence a behavior; they are indications of how hard people are willing to try, of how much of an effort they are planning to exert, in order to perform the behavior. As a general rule, the stronger the intention to engage in a behavior, the more likely should be its performance. A *behavioral* intention can find expression in behavior only if the behavior in question is under strong-willed (volitional) *control*, i.e., if the person can decide at will to perform or not perform the behavior. The performance of most intended behaviors depends at least to some degree on such non-motivational factors as availability of requisite opportunities and resources (e.g., time, money, skills, and cooperation of others). Collectively, these factors represent people’s actual control over the behavior (based on Ajzen 1991).

- Behavioral beliefs: The attitude toward the behavior refers to the degree to which a person has a favorable or unfavorable evaluation or appraisal of the behavior in question. Closely related to the expectancy-value model (referred to later), in this fashion, *people learn to favor behaviors which they believe have largely desirable consequences* and they form unfavorable attitudes toward behaviors that people associate with mostly undesirable consequences.
- Normative beliefs: The subjective norm, a social factor that refers to *the perceived social pressure to perform or not to perform the behavior*. Normative beliefs are concerned with the likelihood that important “referent” individuals or groups approve or disapprove of performing a given behavior.
- Control beliefs: The degree of perceived behavioral control which refers to *people’s perception of the ease or difficulty of performing the behavior of interest*.<sup>25</sup> This dimension is considered to be of greater psychological interest than actual control.

The strength of one’s behavioral intention is driven by someone’s behavioral belief and regulated by someone’s normative belief. Perceived behavioral control, together with this behavioral intention, can be used directly to predict behavioral achievement. But it should be noted that behavioral achievement is expected to vary across behaviors and situations (context specific).<sup>26</sup> Buchan (2005), in his study of ethical decision-making, extended Ajzen’s theory of planned behavior by distinguishing personal, social and organizational factors influencing ethical intentions of auditing professionals.<sup>27</sup>

The aspect of *personalized interpretation* driving behavior is also seen in the “upper echelon theory”, following the behavioral theory of the firm (e.g., Cyert and March

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<sup>25</sup> Importantly, perceived behavioral control differs greatly from Rotter’s (1966) concept of perceived locus of control (see § 2.4.4 in this thesis). Whereas locus of control is a generalized expectancy that remains stable across situations and forms of action, perceived behavioral control can, and usually does, vary across situations and actions. Thus, a person may believe that, in general, her outcomes are determined by her own behavior (internal locus of control); yet at the same time she may also believe that her chances of becoming a commercial airplane pilot are very slim (low perceived behavioral control) (Ajzen 1991).

<sup>26</sup> Ajzen’s theory of planned behavior, an extension of the theory of reasoned action of Ajzen and Fishbein, was born out of the notion that behavior cannot be predicted based on the general behavioral traits or attitudes, but that these behaviors must be analyzed *within the specific context* in which these behaviors are conducted: “Much has been made of the fact that general dispositions tend to be poor predictors of behavior in specific situations. (...) The failure of such general attitudes to predict specific behaviors directed at the target of the attitude has produced calls for abandoning the attitude concept. (...) In a similar fashion, the low empirical relations between general personality traits and behavior in specific situations has led theorists to claim that the trait concept, defined as a broad behavior disposition, is untenable. (...) One proposed remedy for the poor predictive validity of attitudes and traits is the aggregation of specific behaviors across occasions, situations, and forms of action. The idea behind the principle of aggregation is the assumption that any single sample of behavior reflects not only the influence of a relevant general disposition, but also the influence of various other factors unique to the particular occasion, situation, and action being observed [which] (...) represents a more valid measure of the underlying behavioral disposition than any single behavior” (Ajzen 1991: 180).

<sup>27</sup> He has found partial support for the applicability of the theory in predicting ethical intentions of public accounting professionals.

1963).<sup>28</sup> One of the moderating factors in an executive’s behavior would be an executive’s personalized discretion in his/her *interactions* with the organization and the external environment, constrained by a host of conventions and norms (Hambrick 2007). The actual decisions will reflect their personal background and disposition; hence, the psychological and cognitive traits and societal values. Also more at the organizational level, it is noted, for example by Schein (2004), that the behavior of people in organizations is predominantly determined based on the messages they think to receive about what is really valued in the organization.

Following these different definitions and theories of behavior, the definition of professional behavior used in this study is based on the notion that professional behavior is:

- driven by one’s human nature and personal needs, motivations, ethics, and psychological cognitions and limitations;
- guided and controlled by internalized values and beliefs that are shaped by personalized interpretations of national, professional, and organizational cultures, conventions, and norms;
- conditioned by the external constraints and situational contingencies from discretionary interactions with external actors and the profession’s immediate business environment;
- leading to “actions”, being the actual professional behaviors visible to the outside world, and a certain “end result” or performance.

## **2.3 The behavior of assurance professionals**

### **2.3.1 The assurance profession**

The fundamental principles and *raison d’être* of the assurance profession<sup>29</sup> can be found in the agency theory (Jensen and Meckling 1976; Fama and Jensen 1983; Watts and Zimmerman 1983); the separation of control (a small group of management) and ownership (an oftentimes diffuse group of shareholders). Given the assumed self-serving behavior of management, the shareholders cannot always assume the reliability

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<sup>28</sup> In the upper echelon theory, it is explicitly considered that “executives act on their personalized interpretations [and that] these personalized construals are a function of the executives experiences, values and personalities” (Hambrick 2007: 334), which would comprise an executive’s demographic characteristics and background (including national culture) as an indicator of an executive’s frame of reference. Such personalized interpretations are culture specific, as Carpenter et al. (2004) argue when they question the universality of the “top management team” construct in the “upper echelon theory”. National culture would be part of the environmental contextual factors in Carpenter et al’s adapted model of executive behavior.

<sup>29</sup> The terms assurance and audit are used interchangeably, as in the audit profession and the assurance profession and in auditors and assurance providers. The term assurance reflects the more developed and wider profession (see § 2.3.1) compared to the more traditional and commonly used term of auditing and accounting.

of the financial reporting by management<sup>30</sup> (one of the main governance mechanisms to bridge the information asymmetry). On the other hand, they do not have the resources, access and organization to verify the accuracy thereof themselves. The audit profession finds its origin in the verification of such management's assertions in the financial reporting to the shareholders and other stakeholders – an independent external audit of the financial statements (e.g., Schilder et al. 2002).<sup>31</sup> Capital markets are the modern center court of the agency theory. Its efficiency depends, among other things, on the availability of reliable (non-)financial information about the condition of the firms whose stock is publicly traded. "The credibility added to a [company's] financial statements by the "clean" audit opinion is the central reason for an audit firm's existence" (Wyatt 2004: 49).<sup>32</sup>

International accounting firms are among "the most commonly recognized professional businesses" (Alvesson 2004: 32). As Larson more generally states (1977: X):

Professions are occupations with special power and prestige. Society grants these rewards because professions have special competence in esoteric bodies of knowledge linked to central needs and values of the social system, and because professions are devoted to the service of the public, above and beyond material incentives.<sup>33</sup>

The assurance profession meets the traditional characteristics for being a profession that emerge from various scholars (e.g., Sorensen and Sorensen 1974; Burns and Haga

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<sup>30</sup> The auditing profession in the Netherlands, for example, is considered to have originated out of the Pincoffs affair of 1879. In that year, the Dutch society was confronted with a large fraud, the so-called Pincoffs affair. When Pincoffs' African Trade Company suddenly became bankrupt, the trade activities were found to be highly speculative while the balance sheet turned out to be completely false. As a consequence, his partner, who was a famous banker, lost a considerable amount of money for that time period. This disaster induced several accountants in the 1880s to establish themselves as independent auditors, which in turn led to the first institution for accountancy as a body of professionals, the Netherlands Institute of Accountants in 1895 (based on, e.g., Blokdijs et al. 1995: 23-24).

<sup>31</sup> Auditing may be characterized as a process of assuring the validity of an assertion vis-à-vis specified criteria and reporting the findings to interested parties. Financial statement auditing is the most common form. The assertions to be audited concern economic transactions into which an organization has entered, the criteria used are generally accepted accounting principles (GAAP). Ultimately, if the auditor concludes that the assertions in the financial statements are in accordance with GAAP, he or she issues a report communicating that message. Otherwise, the auditor requires an adjustment to the assertion or would issues a report indicating that the financial statements depart from GAAP (based on Solomon and Shields 1995).

<sup>32</sup> "Investors depend upon the integrity of the auditing profession. In its absence, capital markets would lack a vital base of trust" (The Economist 20 November 2004).

<sup>33</sup> Larson defines professionalization as (1977: XVI): "The process by which producers of special services seek to constitute and control a market for their expertise. (...) An attempt to translate one order of scarce resources – special knowledge and skills – into another – social and economic rewards. (...) It must be specific enough to impact distinctiveness to the professional "commodity"; it must be formalized or codified enough to allow standardization of the "product" – which means, ultimately, standardization of the producers. And yet it must not be so clearly codified that it does not allow a principle of exclusion to operate: where everyone can claim to be an expert, there is no expertise".

1977; Larson 1977; Alvesson 2004; Barley and Kunda 2004; Almer et al. 2005), although the modern profession is more and more a business case.<sup>34</sup>

The development of the auditing profession is characterized by large changes in the organizational structures of international accounting firms, which have grown from sole practitioners to multinational professional service firms<sup>35</sup>, currently known as the Big 4 auditing firms. The Big 4 audit firms operated under the brand names of Deloitte, Ernst & Young, KPMG and PricewaterhouseCoopers, each with global revenues of USD 13 to 17 billion and 100,000 to 150,000 employees. In 1970, there were eight such firms but a series of mergers in 1989 created the “Big 6”, the 1998 merger of Price Waterhouse and Coopers & Lybrand reduced this to the “Big 5” and the 2002 collapse of Arthur Andersen has left the “Big 4”. “The firms are organized as networks of member bodies, each of which is a separate and independent legal entity under the global firm. Despite this legal structure, they are to an increasing extent acting more and more like one entity – forcing members of the firm to closely follow the policies of the global firm” (Humphrey et al. 2009).

The global demand for professional assurance, tax, and management advisory services by large and often multinational clients is the primary driver for the international growth strategies of the assurance firms. Some emphasize the importance of the rise of these Big 4 audit firms to the world economy and the global capital markets (Sharma 1997: 758; Greenwood et al. 2005: 662). Others, on the contrary, emphasize that these organizational forms are among the root causes of the demise of professional values in favor of commercial preferences.<sup>36</sup>

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<sup>34</sup> Alvesson, for example, notes that professions’ self-descriptions seem to come from public relations departments of the professional bodies, emphasizing themes such as the profession’s vital role to society, affective neutrality, and altruistic service to clients. But actually that “[s]elf-interest and efforts to attain social closure (excluding other people from the right to certain jobs or tasks) are crucial for professions. Professionalization is very much about politics and the struggle for status, power, and material reward” (2004: 34).

<sup>35</sup> Suddaby, Greenwood and Wilderom (2008: 989) paint a clear picture of the unique character of the international accounting firms as professional service firms: “The uniqueness of professional service firms (PSFs) has been well established. Accounting, law, engineering, and management consulting firms are known to differ significantly from both traditional manufacturing and service organizations in their organizational and managerial arrangements. Their performance depends heavily on the reputation and status of their workforce. They utilize unique employment practices and leadership behaviors, and typically have unusual structures. They are subject to exhortations from external professional bodies and are expected to balance pressures of commercial success with professional integrity. Many professional service firms are governed as partnerships, which, though not unique to these organizations, is highly unusual elsewhere and carries unusually high risks of litigation. These distinctive and differentiating features occur because of unique challenges that arise from the PSFs central focus upon intellectual capital and expert knowledge and the delivery of intangible, customized services through highly trained professionals. The crucial role that professional service firms play in the global economy is also well established. (...) International accounting firms rank among the worlds’ largest organizations, both in measures of size and revenue”.

<sup>36</sup> Brint (1994, quoted in Suddaby et al. 2009: 411), for example, argues that while the number of professionals in society is rapidly increasing, the assumed gap in value preferences between professionals and commercial businesspersons is decreasing. He observes that the historical value set of professionals as “social trustees” is being replaced by a value set of “professional expertise”. While the former value set characterizes professional work as a “calling” imbued with obligations of public duty, the more current



Next to the more general professional autonomy and professional status, the typical characteristic of the assurance profession is the sensitive balance between an “intimate” client relationship, personal incentives, accountability towards a wide variety of third parties (as in the agency theory), and explicit professional requirements of objectivity and independence. Furthermore, auditors have extensive access to proprietary, strategic, product, and financial client information, and consequently are subject to confidentiality requirements (e.g., Almer et al. 2005).

The codification and standardization of the assurance profession is primarily done through the International Federation of Accountants, the IFAC.<sup>37</sup> The IFAC, through its independent standard-setting boards, and in conjunction with the international regulatory community, sets, among others, international auditing and assurance standards and a code of ethics for professional accountants. The International Standards on Auditing (ISAs) are currently used by more than 100 jurisdictions around the world. These standards are so-called “principles-based” which means that the nature of the international standards is such that it required auditors to exercise professional judgment in applying them. The overall objectives for the auditor are:

to obtain *reasonable assurance* about whether the financial statements as a whole are free from material misstatements, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared *in all material respects*, in accordance with an applicable financial reporting framework (ISA 200.11, emphasis added).<sup>38</sup>

The audit production process is based on the *audit risk model* <sup>39</sup> (e.g., Eilifsen et al. 2001; Knechel 2001, 2007) and an effective and efficient mix of appropriate audit steps (e.g., Schilder et al. 2002; Quick et al. 2008)<sup>40</sup>.

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value set views professional work in technocratic terms based on the market value of their knowledge and expertise. Modern professionals “only rarely remark on the ‘social importance’ of their work”.

<sup>37</sup> The IFAC is the global organization for the accountancy profession. IFAC comprises 157 member bodies and associates in 122 countries. Through them, the IFAC represents approximately 2.5 million accountants in public practice, education, government service, industry, and commerce.

<sup>38</sup> This objective holds two fundamental principles of the audit profession: reasonable assurance and materiality. “Reasonable assurance” means that, although it is considered a high level of assurance, it is not an absolute level of assurance. An inherent, but low risk remains that the wrong audit opinion is issued due to inherent limitations of an audit “which result in most of the audit evidence (...) being persuasive rather than conclusive. Reducing the risk of not detecting all material misstatements to zero to obtain absolute assurance that the financial statements are free of all material misstatements is rarely attainable or cost beneficial” (Quick et al. 2008: 3). By “in all material respects” the profession refers to the inherent limitation to audit in the smallest detail, which also would not be cost-benefit efficient. Therefore, an auditor applies a “bottom” amount in performing an audit, meaning that misstatements below that bottom amount may well not be identified and corrected (i.e., the financial statements could still comprise errors, but not higher than the “materiality”).

<sup>39</sup> The audit risk model is designed to minimize the risk of reaching the wrong conclusion based on the work performed and, consequently, not issuing the appropriate audit opinion. This “audit risk” has been conceptualized as a function of inherent risks, control risks, and detection risks.

<sup>40</sup> The typical audit (production) process comprises audit planning, risk assessments, audit procedures, and evaluation of audit evidence (Quick et al. 2008). There is no standard set of audit procedures and the

Since the origin of the audit profession, an “expectation gap” exists between the stakeholders’ perceptions of audit quality and the actual audit process and reporting, which, among others, has been central in Limperg’s theory of rational expectations.<sup>41</sup> This has been a much debated and studied phenomenon (e.g., Porter 1993; Epstein and Geiger 1994; McEnroe and Martens 2001) wherein it has been shown that a wide variety of expectations exists which the profession hardly can meet (if, at all). Anderson, in his OECD report on corporate governance in response to the financial crisis, is among the most recent that are skeptical about the audit profession’s ability to close this expectation gap (Anderson 2009: 20):

The model has struggled over the course of the twentieth century to keep up to date with stakeholder perceptions. For example, audit is not expected to identify all frauds, and yet there is still a perception in some comparatively sophisticated quarters that it should do so. (...) [I]t would seem that the gap between what the users of the accounts (politicians, the public, the economic system) believe they can read into the accounts, and what the auditors mean when they opine, continues to grow. A “clean” or unqualified audit report is seen as a general badge of health for the organization, and yet in reality the audit is addressing a diminishing proportion of the risks that an organization faces. (...) Neither the financial statements, nor the audit address many of the forward looking risk issues that are of interest to stakeholders today. In particular they do not address the sustainability of the business model, nor do they look in any depth at systematic risks in an industry or economy as a whole.

Anderson continues to say that this perception issue is exacerbated “by the comparative rarity of issuing a qualified audit report, which in itself has the potential to be the final demonstration of frailty that could bring a [company] down” (2009: 21). He advocates the exploration of a much more gradated approach to audit reports “which could signal more subtle differences between banks without catastrophically undermining the [company] in question”. But Anderson also acknowledges the litigiousness of the (audit) environment, hampering any innovative spirit that may already exist.

Central in the innovation efforts of the audit profession is the “assurance framework” (the International Framework of Assurance Engagements). There is a trend towards increasing the pallet of assurance services.<sup>42</sup> Continuous professional efforts to build-out the “assurance framework” are an example of efforts to bring in additional work within the exclusive boundaries of the audit profession. More recent

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auditor has to determine the most effective and efficient mix of audit procedures. The audit process has been broken down into as much as 332 individual audit tasks (Abdolmohammadi 1999).

<sup>41</sup> Limperg’s theory states that “the auditor should act in such a way that he/she does not disappoint the expectations, while, on the other hand, he/she should not arouse greater expectation in his/her auditor’s report than his/her examination justifies” (Blokdijs et al. 1995: 23-24).

<sup>42</sup> “Assurance services are professional services for the use by decision makers, designed to enhance the credibility of information that is the responsibility of another party by evaluating that information against suitable criteria” (Hayes et al. 2005: 468).

examples are non-financial assurance services on environmental and sustainability reports and behavioral assurance services such as governance and culture assessments (the latter receiving support from governmental institutions such as the G20 and OECD, which identified a need for increased internal and external assurance). The expanding scope of assurance services may, however, “involve many different user groups and different types of reports providing different levels of assurance” (Trotman 2005). This poses a challenge to the appropriate communication of the oftentimes limited assurance provided (see, for example, Hasan et al. 2003). A limitation in practice is that users tend to gain comfort from the brand name of the audit firm providing assurance, rather than that they themselves establish which level of assurance is actually provided. Knowing this, an audit firm’s reputation is of the greatest importance, foremost in relation to its influence on auditors’ behavior.

A specifically interesting aspect in this respect currently is the “society granted privilege” of self-regulation; an ever-had privilege that the assurance profession recently lost.<sup>43</sup> As DeFond and Francis illustrate (2005: 5):

While the beginning of the 21st century has been marked by accounting scandals<sup>44</sup>, a major stock market crash, and the most sweeping securities market reforms since the 1930s, one unexpected consequence of these events is an increased awareness that auditing matters. (...) Along with this greater appreciation, however, is also widespread criticism that many aspects of auditing are “broken” and in need of fundamental reform.

Wyatt (2004) notes that the profession, or the society as a whole, has paid a high price for the accounting profession’s failure during the Enron and Arthur Andersen affairs to meet the expectations of investors, creditors, and other users of financial statements (i.e. changing equilibrium). He analyzes that forces as “corporate and individual greed, (...) becoming too cozy with clients, and participating actively in finding ways to avoid the provisions of accounting standards” (2004: 45) played a significant role. Sikka (2009a) even questions whether the private sector model of

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<sup>43</sup> This is illustrative of what Larson already theorized (1977: XII); “If professions obtain extended powers of self-evaluation and self-control they can become almost immune to external regulation. The fact remains, however, that their privileges can always be lost. (...) Revolutionary social change should therefore have profound implications for professional practices because it affects the social status that established professions had achieved in previous regimes”.

<sup>44</sup> As Moore et al. illustrate (2006: 13): “Andersen’s audit of Enron may have been the most notable failure (...), but it was by no means the first, the largest, or the last. The earnings restatement that precipitated Enron’s fall revised the company’s profits downward by \$650 million. Yet prior to the Enron scandal, Waste Management overstated earnings by \$1.43 billion over a five-year period, and U.S. regulators found that the company’s auditor, Arthur Andersen, conspired to hide accurate accounting data from the public. Since Enron’s fall, WorldCom, another Andersen client, revised its profit reports downward by a shocking \$9 billion. (...) These cases are only the most vivid of the multitude of cases in which the major auditing firms paid to settle lawsuits or lost cases in the courts”.

auditing is attainable and suggest that alternative institutional arrangements should be considered (e.g., state auditors).<sup>45</sup>

In response to the accounting scandals, US Congress passed the Sarbanes-Oxley Act in 2002 (SOX) and installed the Public Company Accounting Oversight Board (PCAOB, comprising a majority of non-accountants). With the creation of the PCAOB and similar professional supervisors in many other countries (like the Authority for the Financial Markets in the Netherlands), the accounting profession is no longer self-regulated – although others are of the opinion that the loss of self-regulation has been a gradual, “slippery-slope” process.<sup>46</sup> Overall, these new regulations transformed assurance profession “from a self-regulated industry that is overseen by a government agency to an industry that is now directly *controlled* by a quasi-governmental agency, the PCAOB” (DeFond and Francis 2005: 6). Whether that solves the problem remains to be seen. Auditors have taken some criticism in the recent commentaries on their role in the Lehman Brothers’ downfall: “Investors would like to think that auditors consider not just the letter of the rules but their spirit, too” (Economist 20 March 2010). Sikka, consistent with its prior stance, replied on that commentary by saying: “The guards are in bed with their prisoners”.

### 2.3.2 The codified values of the assurance profession

The Code of Ethics for Professional Accountants (hereinafter: Code of Ethics) (IFAC 2009a)<sup>47</sup> is the “codified discourse” of the assurance profession’s core values and attitudes. The Code of Ethics comprises, in very general terms, the behavior that professional auditors are expected to uphold. It *drives* behavior rather than that its terms *are* behaviors. As Magala states (Magala 2009: 4): “[Values] inspire our actions, legitimize our pursuits, power our beliefs or decorate our self-justification”. The Code

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<sup>45</sup> Sikka (2009a: 34) reasons in relation to the basis auditing business model: “The auditing firms are capitalist enterprises and are dependent upon companies and their directors for income. The fee dependency impairs claims of independence and has the capacity to silence auditors. It poses fundamental questions about the private sector model of auditing which expects one set of capitalist entrepreneurs (auditors) to regulate another set of capitalist entrepreneurs (company directors)”.

<sup>46</sup> DeFond and Francis (2005: 11) opine that the loss of self-regulation has been gradually, but was finally triggered by Enron’s collapse in December 2001: “We believe one critical trigger occurred when Deloitte & Touche issued a ‘clean’ peer review report on Arthur Andersen in December 2001, just a few weeks before Andersen publicly announced that it had shredded documents related to the Enron audit. The credibility of the entire accounting profession was immediately in doubt along with the credibility and integrity of the profession’s self-regulation program”. The “clean” peer review report, that concluded that Andersen’s system of accounting and audit quality provided reasonable assurance of compliance with professional standards, was based on 240 audit engagements in more than 30 Andersen offices but did not include the Enron audit (Chaney and Philipich 2002).

<sup>47</sup> On 10 July 2009, the IFAC issues its revised Code of Ethics for Professional Accountants. This code is effective as per 1 January 2011, but with its 2009 publication clearly the most current reflection of the societal consensus of generally accepted behavior of professional auditors. The 2009 Code further clarifies requirements and significantly strengthens the independence requirements of auditors. These comprise, among others, revisions to prevent cross-selling practices and possible job-opportunities that would create incentives that are more dominant than providing quality audit.

of Ethics requires accountants to adhere to five fundamental principles (based on IFAC 2009a):

- *Integrity*: to be straightforward and honest in all professional and business relationships. Integrity also implies fair dealing and truthfulness;
- *Objectivity*: to not allow bias, conflict of interest or undue influence of others to override professional or business judgments;
- *Professional competence and due care*: to maintain appropriate professional knowledge and skills and to act diligently and in accordance with applicable technical and professional standards;
- *Confidentiality*: to respect the confidentiality of information acquired as a result of professional and business relationships and, therefore, not disclose or use the information for the personal advantage of the professional or a third party; and
- *Professional behavior*: to comply with relevant laws and regulations and avoid any action that discredits the profession.

One would expect to find more guidance about the meaning of “professional behavior”. But unfortunately the additional guidance of the Code of Ethics is also limited to fairly generic principles of compliance and socially acceptable behavior, good reputation of the profession, acting honest and truthful, and to manage the expectations of the general public.<sup>48</sup> It, thus, leaves it to the professional accountant to interpret what professional behavior means in daily practice.<sup>49</sup> It is interesting then, that Pflugrath et al. have shown that although “the presence of a code of ethics has a positive impact on the quality of the judgments made by professional accountants, [it is only effective] in the context of greater general experience that leads to higher quality of judgments” (2007: 566). In other words, codes are subject to judgment and less effective with inexperienced auditors.

“Independence” as such is not part of these five fundamental requirements, because these apply only to auditors providing audit and assurance services in public practice (i.e., not to auditors that are employed by corporations in functions such as internal auditors). The independence requirements play a significant role in auditors’ behavior and center around five so called “threats” (section 290 of the Code of Ethics, 2009a): self-interest, self-review, advocacy, familiarity and intimidation. The

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<sup>48</sup> In section 150 of the Code of Ethics compliance and socially acceptable behavior is referred to as to “include actions that a reasonable and informed third party, weighing all the specific facts and circumstances available to the professional accountant at that time, would be likely to conclude adversely affects the good reputation of the profession”. It further refers to one part of Limperg’s theory of rational expectations: “professional accountants shall be honest and truthful and not make exaggerated claims for the services they are able to offer, the qualifications they possess, or experience they have gained”.

<sup>49</sup> These ‘terms’ of professional behavior arise from the interaction between three groups (Neale 1996): interaction with the general public, interaction with clients, and intra-professional interaction. “The behavior of an individual professional interacting with another of the parties is acceptable conduct if it would be acknowledged as acceptable by all three groups” (Neale 1996: 221). However, a professional code of ethics “is worth nothing [unless] it plays a significant role for the professionals, and even then, critical scrutiny of how the code works in practice is called for” (Alvesson 2004: 34).

Code of Ethics further distinguishes independence *in mind* and independence *in appearance* (Section 290.6).<sup>50</sup> Although, independence may be controlled at the office or firm level, the more significant level of interest is that of the local office or even the individual, e.g., in relation to incentives that can impact or impair independence at an individual level.<sup>51</sup> Bazerman et al. (2002: 99), for example, point to the risk of individual bias due to attachment as “individual auditors’ jobs and career may depend on success with specific clients”. Sikka (2009b) also points to the fee dependency and related career advances creating conflicts of interest, and relates this to audit failures in the current financial crisis. And Moore et al. (2006) even point to the inherent limitations of trying to safeguard personal independence, due to what they call “moral seduction” and “unconscious bias”. Carcello (2005) points out that “[t]he problem with using firm-wide measures is that local audit teams, rather than the national firm as a whole, perform audits” (2005: 36).

The “modal collective agreement on meanings and interpretation” (House et al. 2004: 103) is further laid out in IFAC’s International Standards on Auditing (IFAC 2009b). Avoiding ambiguity in interpretation of the standards, within the concept of applying professional judgment, was among the key objectives of the ISA Clarity Project.<sup>52</sup> These standards are so-called “principles-based” which means that the nature of the international standards is as such that it required auditors to exercise *professional judgment* in interpreting and applying the standards. This does leave room for “personal interpretation”, which is emphasized by the IFAC itself. They recently called to “embrace issues in spirit rather than in letter”<sup>53</sup>. This sets the already principles-based standards open to multiple interpretation, for example as a consequence of cross-national cultural differences. However, the ISAs explicitly state that “professional judgment is not to be used as the justification for decisions that are not otherwise supported” (ISA 200.A27).

The main requirements of the ISAs directing auditors’ behavior in conducting an audit are (based on ISA 200.14-24):

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<sup>50</sup> Independence in appearance is to avoid circumstances based on which a reasonable and informed other would be likely to conclude that an auditor’s “integrity, objectivity or professional skepticism has been compromised” (IFAC 2009a, section 290). Independence in mind is related to the state of mind that allows the auditor to act with integrity, objectivity and professionally skeptical in his professional judgment.

<sup>51</sup> This is supported by, for example, DeFond and Francis (2005: 14) who point out that “the economic importance of (large) clients is more salient at the office level”. Carcello (2005) particularly emphasizes “the importance of studying auditor behavior using the office or individual partner as the unit of analysis” (2005: 36). Reynolds and Francis (2000) study is an example of office-level analysis.

<sup>52</sup> On 3 March 2009, the International Auditing and Assurance Standards Board issued the completed set of clarified International Standards on Auditing and International Standards on Quality Control. “With the completion of the Clarity Project, the IAASB has issued all its auditing standards in a form designed to enhance the understanding and implementation of them, as well as to facilitate translation” (IAASB 3 March 2009).

<sup>53</sup> In their recommendations to the G20’s plans to enhance sound regulation and strengthen transparency in response to the financial crisis, the IFAC points to the ineffective operation of risk management systems due to “a failure to follow good practices and to embrace issues in spirit rather than in letter” (IFAC 29 March 2009).

- Complying with the relevant ethical requirements (i.e., the Code of Ethics)
- Applying professional skepticism (i.e., skeptical judgment and decision-making)
- Exercising professional judgment (i.e., judgment and decision-making)
- Obtaining sufficient appropriate audit evidence (i.e., the audit process)
- Conducting an audit in accordance with the ISAs (i.e., rule observance).

ISA 220 on quality control for an audit engagement further substantiates these behavioral requirements by articulating that, for example, the auditor shall (based on ISA 220):

- be satisfied that the engagement team members have the appropriate competences and capabilities;
- take responsibility for the direction, supervision and performance of the audit in compliance with the standards;
- take responsibility for reviews being performed, and perform him/herself reviews of audit documentation and discussions with the audit team (based on which the auditor shall become satisfied that sufficient appropriate audit evidence was obtained);
- be satisfied that appropriate consultations have been undertaken, both within the audit team and with other experts;
- take responsibility for appropriate documentation of audit work performed and conclusions reached; and
- take responsibility for the appropriateness of the audit reporting, including the communication with the client (management and those charged with governance).

The public trust in the auditing profession depends, among others, with the compliance of its associated auditors with these professional rules of conduct. Preventing non-compliance or preserving quality is the main objective of the professional (supervisory) bodies and assurance firms' own quality controls.<sup>54</sup> As the outcome of auditing and auditors' judgment and decision-making mostly cannot be simplified to be either correct or not, but rather is a matter of professional judgment, a process-oriented approach to compliance is used in auditing "The accounting profession has developed *standards and procedures* that legitimize decisions and that are used in practice to evaluate the work of [auditors]" (Bédard and Chi 1993: 29-30). This is why the auditing standards include *compliance* with relevant ethical standards and auditing standards as one of their fundamental behavioral principles, with a focus on as high as possible *technical* audit quality.

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<sup>54</sup> The IFAC's International Standard on Quality Control 1, for example, dealing with an audit firm's responsibilities for its system of quality control, was introduced with an aim to restore public confidence after the financial debacles such as Enron-Arthur Andersen (Pflugrath et al. 2007).

## 2.4 Auditors’ professional behavior

In this study, the actual professional behaviors of auditors do not only comprise the audit-technical behaviors of actually performing an audit (i.e., the core audit process). They also include those key behaviors of an auditor’s functioning holistically (i.e., the broader functioning of the auditor including such behaviors as practice development and client relationship management).

Central to the professional behavior of auditors is the audit judgment and decision-making process while performing audit tasks. This also includes the profession’s core competence: the audit process and performing audit tasks. Some behaviors – behaviors that are part of and contribute to that decision-making and audit process – are highlighted separately due to their significance to the audit process. These are: skeptical judgments and decisions (i.e., probing and being professionally skeptical), knowledge sharing and consultation behavior, working in fluid and flexible audit teams (including engagement partner involvement), communication of and negotiation on audit observations and findings, and audit documentation and justification. Dysfunctional or deviant behaviors are those behaviors that are counter-productive and are covered separately. Factors that are related to the broader functioning of auditors are covered under the heading audit pricing and practice development.

Based on a review of the auditing and accounting literature<sup>55</sup> (e.g., Birnberg and Shields 1989; Greenwood et al. 1990; Covaleski et al. 1998; Solomon and Trotman 2003; Almer et al. 2005; Nelson and Tan 2005; Trotman 2005; Bédard et al. 2008a; Jenkins et al. 2008), and more specifically the literature within the behavioral study of accountants (e.g., Ferris 1981; Dillard and Ferris 1989; Ferris 1990; Schlachter 1990; Sorensen 1990; Libby and Luft 1993; Malone and Roberts 1996), the auditors’ behaviors identified in this study, and covered in more detail in the next sub-sections, comprise the following:

- Judgment and decision-making
- Skeptical judgments and decisions
- Knowledge sharing and consultation behavior
- Working in fluid teams (engagement partner involvement)
- Communication and negotiation behavior on observations and findings
- Documentation and justification
- Dysfunctional behaviors
- Audit pricing and practice development.

Below, I discuss these eight behaviors of professional auditors in more detail.

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<sup>55</sup> Literature review was conducted through the following steps: (a) review of the research provided by leading scholars in the field of (professional) behavior in general; (b) review of research syntheses in the leading (behavioral) auditing journals; (c) review and follow-through of the literature of behavioral scientists both inside and outside the field of auditing or professional service firms; and (d) citation data and analysis is employed as a means of identifying and judging relevant papers and their scholarly impact (through the use of Scopus).



### 2.4.1 Judgment and decision-making

Central to the professional behavior of auditors is the audit judgment and decision-making process. “Judgment” refers to “subjective assessments made as a prelude to taking action”, where “decisions” mean “*actions* that people take to perform some task or solve some problem” (Solomon and Trotman 2003: 396). Judgment and decision-making research in auditing<sup>56</sup> focuses on the nature and complexity of and on “how experienced auditors form judgments or make decision *while performing audit tasks*” (Solomon and Shields 1995: 137).<sup>57</sup> Judgment and decision-making, thus, includes the profession’s core competence: the audit process and performing audit tasks (i.e., the process from client acceptance to external audit reporting). This is also seen in the centrality of “professional judgment” in the auditing standards.<sup>58</sup>

The audit (production) process comprises audit planning, risk assessments, audit procedures, and evaluation of audit evidence (e.g., Schilder et al. 2002; Quick et al. 2008). There is no set standard audit procedures, but the auditor has to determine (judge and decide on) the most effective and efficient mix of audit procedures. Also, the number of audit tasks illustrates the magnitude of the (many small and larger) judgments and decisions required in an audit. Nelson and Tan (2005) found that much of the audit task research focuses on the main phases of the audit process: risk assessments (including the audit risk model and related audit planning decision), analytical procedures and evidence evaluation, auditors’ correction decisions (whether or not changes need to be made to the financial statements), going-concern judgments, and fraud detection.

The less structured the audit tasks are or the more complexity and ambiguity they comprise, the more judgment generally is required (e.g., Abdolmohammadi and Wright 1987; Bonner 1994; Solomon and Shields 1995). Nelson and Kinney (1997),

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<sup>56</sup> The central themes of judgment and decision-making research in auditing are threefold: assessing decision performance, establishing the factors which determine decision performance, and testing theories of the cognitive processes which produce the decisions (Libby and Luft 1993: 425). It draws from multiple academic disciplines such as cognitive and social psychology. “Judgment and decision-making research in auditing uses a psychological lens to understand, evaluate, and improve judgments, decisions, or choices in an auditing setting” (Nelson and Tan 2005).

<sup>57</sup> Judging and deciding are inherent in every phase of the audit process (Solomon and Shields 2005). For example, when focused on a specific financial statement assertion and account balance (e.g., valuation of inventory), the auditor must *judge* the significance of the balance and assertion, how much risk there is of misstatement, how to best produce evidence to confirm or disconfirm this assertion, how much such evidence should be produced, and when during the course of the audit it should be produced (which process comprises many (small) decision). Subsequently, the auditor must evaluate the resulting evidence and form a judgment about its meaning. Together with the judgments made for other accounts, transactions and assertions, the auditor then must integrate these findings and *decide* what to communicate to the financial statement users (i.e., choose the audit report to be issued) (based on Solomon and Shields 2005).

<sup>58</sup> “Professional judgment is the application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed *decisions* about the courses of action that are appropriate in the circumstances of the audit engagement” (ISA 200.13k, emphasis added).

for example, showed that more ambiguity leads auditors to be more conservative in their judgments. Pincus (1990) evidenced that auditors who are less comfortable in dealing with ambiguity (i.e., ambiguity-intolerant auditors) show higher decision-making performance (i.e., made better judgments in misstatement cases).

Other factors that determine judgment and decision-making performance are auditors’ knowledge, experience, and problem-solving abilities (e.g., Bédard and Chi 1993; Libby and Tan 1994; Tan and Kao 1999), and auditor’s confidence (e.g., Pincus 1991; Whitemcotton 1996) heuristics and biases, such as the anchoring heuristic or the confirmation bias (e.g., Shanteau 1989; Bazerman et al. 2002).

The impact of ambiguity on auditors’ judgment and decision-making process is exacerbated by the use of (numeric) probability phrases in auditing and accounting standards, such as “remote”, “low”, “more likely than not”, or “probable”.<sup>59</sup> Interpretation differences of such probability phrases may well result in the inconsistent application of the auditing standards and miscommunication between auditors themselves already. Jiambalvo and Wilner (1985) and Amer et al. (1994), for example, found significant variance between auditors in the interpretation of probability phrases such as stated above. On top of that, Amer et al. (1994) found that auditors were generally not aware of such interpretation differences. This leads to a risk that auditors do not seek to clarify and resolve potential miscommunications. As will be seen in Chapter 4, interpretation differences increase in cross-cultural settings.

Of specific relevance is the auditor’s ethical judgment and decision-making. Several studies have found support for the notion that auditors’ behavior and professional judgment is related to the auditor’s level of moral or ethical reasoning (see Jones et al. 2003 for the most recent overview, including extensions of the Jones model). The four stages of ethical decision-making in the Jones model (based on the studies of Rest referred to in Cohen and Bennie 2006) are:

- Recognition of ethical issue or ethical sensitivity, i.e. interpretation of the situation. The recognition that decisions will affect others and that he/she has a choice.
- Making ethical judgment, i.e., what should be done: Judgment as to what is the ethically correct course of action.
- Establishing ethical intent, i.e., what would be done: Balancing ethical factors against other factors.
- Engaging in ethical behavior, i.e., actual response/action based on his/her intention.

Falk et al. (1999), for example, found that auditors’ appropriate conclusions about whether or not a qualified audit report was necessary, was positively related to their level of moral reasoning.

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<sup>59</sup> Reimers (1992), for example, found that auditors interpret “reasonably possible” to be between 49% and 67% (mean scores, with standard deviations of 14 downwards to 16 upwards).

## 2.4.2 Skeptical judgments and decisions

*In Hans Christian Andersen's fable, "The Emperor's New Clothes", two scoundrels convinced a vain emperor that they could make a magnificent cloth of silk and gold threads invisible only to the incompetent and the stupid. After the emperor gave them money and materials to make the royal garments, they dressed him in nothing at all. Not even the emperor, much less his courtiers, dared to admit to not seeing any clothes for the fear of being branded stupid and incompetent. The public applauded as the emperor paraded in the buff to show off his new 'clothes'. Then a child asked, "Why does the emperor have no clothes?" After a moment of stunned silence, others posed the same question. If the child's words did not change what people saw, then why did they change their minds?*

(taken from Sunder 2002)

Skeptical judgments and decisions (manifestation of professional skepticism) belong to the fundamental professional behaviors of auditors. The importance of professional skepticism is well illustrated by Quadackers (2009: 9):

[I]f there would have been more skepticism on the side of the auditor this could have reduced the effects of major recent business 'improprieties'. (...) [Prior research] found the lack of an appropriate level of professional skepticism to be number 3 (60% of the cases) among the top 10 list of audit deficiencies associated with fraud-related SEC cases. (...) Society trusts financial auditors to exercise professional skepticism in conducting the audit. Therefore, professional skepticism is an essential feature of contemporary audits.

Carpenter and Reimers (2009), in addition, note that "The Public Company Accounting Oversight Board, in its recent auditors inspections, cited a lack of professional skepticism (...) as serious problems for auditors". Quadackers points out that auditors with higher professional skepticism "have a higher need for evidence" (2009: 17) and elaborates by saying that professional skepticism is about a healthy dose of "presumptive doubt" in an auditor's further neutral stance in which the auditor assumes no bias in management's representation *ex ante*, neither in a positive ("trusting") or negative ("suspicion") direction. Professional skepticism "includes *questioning* contradictory audit evidence and the reliability of documents and responses to inquiries and other information obtained from *management and those charged with governance*" (ISA 200.A20, emphasis added).

Professional skepticism also means being aware of the inherent biases influencing the auditor's behavior. It concerns reducing the risk of "using inappropriate *assumptions* in determining the nature, timing, and extent of audit procedures and evaluating the results thereof" (ISA 200.A19, emphasis added). Quadackers (2009) found that interpersonal trust and suspension of judgment are among the most significant biases in skeptical judgments and decisions of auditors.<sup>60</sup> This concept is

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<sup>60</sup> Interpersonal trust in relation to professional skepticism is defined as a general expectancy held by an individual or a group that the word, promise, verbal or written statement of another individual or group can be relied upon (Quadackers 2009). Suspension of judgment would be most closely related to the anchoring adjustment heuristics and the confirmatory bias. Suspension of judgment is the opposite of

subsequently “unzipped” in honesty and integrity (trust in management’s word), institutional trust (trust in the situation or structure), and exploitation (the expectation whether people behave exploitatively and selfishly versus fairly and altruistically).

Professional skepticism, furthermore, has been found to increase with auditors’ career levels and experience (e.g., Shaub and Lawrence 1999; Carpenter et al. 2002), after following a specialized forensic accounting course (Carpenter et al. 2008), and when audit partners emphasize the importance of professional skepticism on their audit teams (Carpenter and Reimers 2009). Professional skepticism is also related to the “persuasion knowledge” of an auditor as studied by Kaplan et al. (2008) and Anderson et al. (2004).

### 2.4.3 Knowledge sharing and consultation behavior

The central importance of knowledge in auditing is illustrated by the common body of knowledge leading to the professional qualification and in the profession’s fundamental behavioral principle of professional competence and due care. “Since knowledge and expertise are unevenly distributed among the personnel in audit firms, it is vital for these organizations to devise methods for sharing of knowledge and know-how” (Jenkins et al. 2008: 60).

Consultation is such a method, but consultation is also a critical process of the quality control and strengthening accountability.<sup>61</sup> Especially where much knowledge within audit firms is tacit and hidden in individual’s values, intuitions, and experiences, knowledge sharing takes place through socialization including processes such as interactive conversations, apprenticeship, storytelling, and training on the job (Nonaka and Takeuchi 1995; Vera-Munoz et al. 2006).

Vera-Munoz et al., in their study on enhancing knowledge sharing in public accounting firms, observe (2006: 133):

an increased recognition that sharing of knowledge among employees is the primary intangible source of sustained competitive advantage, economic growth, and corporate value. (...) Audit firms’ ability to effectively deploy knowledge sharing activities is increasingly vital to their competitive advantage, including gaining tangible benefits in terms of time and costs reductions (...) and enhance quality, effectiveness and efficiency of the audit process.

Furthermore, knowledge sharing contributes to the sharing within audit teams of knowledge and expertise about the client’s environment, industry, business model, and operations, which understanding is essential to the audit. For example, Bédard et al. (1998) show that knowledge sharing adds to audit process gains (e.g., in analytical procedures). Vera-Munoz et al. (2006) conclude that effective knowledge sharing

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cognitive closure. Skeptics do not accept naively the first things they perceive or think but are more critical; they want to see evidence before believing (based on Quadackers 2009).

<sup>61</sup> For example, Kennedy et al. (1997) found that auditors perceive that documented conclusions are more justifiable if the preparer consulted other peers within the firm.

requires more than a technological solution. It requires a culture that simultaneously rewards knowledge sharing and discourages knowledge hoarding as a source of power or job security.<sup>62</sup>

“[T]he issue of consultation has been virtually ignored by the academic literature” (Trotman 2005: 82). In practice, an elaborate network for formal and informal consultations is available:

While informal consultation occurs frequently within engagement teams and among colleagues across teams, accounting firms also enable more formal consultation processes through the establishment of specialized internal groups referred to as central research units (CRU) and accounting consultation units (ACU) (Jenkins et al. 2008: 60).

The consultation procedures referred to in quality control standards is related to more formal consultation procedures within an audit firm. Salterio and Denham (1997) show that, to some extent, a firm’s use of research and consultation units is influenced by its culture.<sup>63</sup> The main benefits of having a consultation unit are the development of more proficient practice staff through short-term rotations and the creation of an organizational memory and consistency of accounting treatments.

#### **2.4.4 Working in fluid teams**

Characteristic for the audit profession is that an audit is conducted in hierarchically structured audit teams<sup>64</sup> the composition of which changes from engagement to engagement (i.e., “fluid audit team”)<sup>65</sup>. Audit judgments and decisions are made in multi-person team structures. Audit teams should reflect the diverse set of appropriate

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<sup>62</sup> They have analyzed the “anatomy” of three factors of knowledge sharing: information technology, formal (e.g., meetings and review) and informal (e.g., through culture and socialization, training on the job) interactions among auditors, and reward systems. As an example of formal knowledge sharing settings, Carpenter (2007) studied the effectiveness of brainstorming sessions to help auditors detect fraud. She found that brainstorming generates more quality fraud ideas (as opposed to the quantity of ideas) and new fraud ideas, compared to the ideas individual auditors generate.

<sup>63</sup> They distinguish “discovering firms” from “conditioned-viewing firms”. Discovering firms rely heavily on consultation, stress consultation at the earliest possible time (e.g., by statements such as “The biggest mistake you can make, is the mistake you make on your own”), promote consultation recourses via periodic newsletters, and use firm-wide peer-review systems. The conditioned-viewing firms are on the other side of this spectrum, meaning that they rely less on formal research and consultations.

<sup>64</sup> Professional standards require auditors at each level to be properly supervised and their work reviewed. This has been operationalized in public accounting by successive levels of supervision (i.e., senior, manager, then partner) (Almer et al. 2005). Generally, less experienced team members carry out specific evidence generating steps and document in working papers the results, while more experienced team members plan the audit procedures, supervise performance, and review the documented work. More experienced members also make decisions to consult with appropriate persons about any special problems that arise (based on Solomon and Shields 1995).

<sup>65</sup> “Fluid” refers to the composition of audit teams that changes from engagement to engagement, i.e. auditors generally work on multiple audit engagements, in multiple teams, with each a different composition.

expertise and skills necessary for the audit. For example, hierarchical teams have shown to be more effective at error detection when the team is comprised of personnel with different necessary skills (Owhoso et al. 2002). In other words, the effectiveness of an audit team can gain from the right mix of diverse talents, cognitive abilities, skills and abilities. Sufficient involvement of the audit engagement partner and consecutive levels of audit (senior) managers is critical for audit engagement performance. This is also recognized by the auditors’ clients’ audit committees, who *perceive* that partner and manager attention that has been given to the audit to have the most significant impact on audit quality, rather than other factors such as independence, expertise of the team, quality controls, or the audit firm’s litigation rate (e.g., Schroeder et al. 1986; Ghebremichael 2006).

Auditors’ working in teams fosters dissemination of organizational knowledge, norms, and values. Almer et al. (2005) note positive features of “fluid audit teams” (e.g., sharing of knowledge, norms and values, early opportunities to supervise, and building a social network), but also point out that the fluid character of audit teams has the potential to hamper trust and deeper relationships among team members. This, in turn, can negatively impact performance appraisals and commitment. In relation to knowledge sharing and education within the team, Bonner and Walker (1994) find that explanatory feedback (i.e., explaining to the “learner” why the given answer was correct or not), coupled with upfront instructions using “understanding rules”<sup>66</sup> promote the greatest degree of knowledge and experience acquisition and experience gaining of audit team members. Thus, this is closely linked to coaching and “training-on-the-job” which can be considered as one of the main training mechanisms within audit firms.

Working in fluid audit teams also serves as a form of control due to individual accountability to many team members over time. Research has shown that accountability within the audit team is induced through the review process as an important safeguard for engagement performance (e.g., Gibbins and Trotman 2002; Pierce and Sweeney 2005: 364).<sup>67</sup> The review process, consequently, is a significant part of teamwork, but accountability research recognizes, however, that “the *prospect* of a review is sufficient to induce greater vigilance among preparers” (Nelson and Tan 2005: 55). Audit team review is more and more an iterative process of verbal interaction and review by interview, as opposed to the more traditional sequential computer-mediated review process (e.g., Rich et al. 1997; Barret et al. 2005; Pierce and Sweeney 2005: 342). This face-to-face review has been shown to strengthen the accountability-inducing effect of the prospect of review (Brazel et al. 2004). However, Wilks (2002) has shown that real-time, face-to-face review also poses a risk for the autonomous decision-making of individual audit team members as they tend to work towards their manager’s views (“stylizing”) and tend to agree with those views as soon

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<sup>66</sup> “Understanding rules” provide explanations with the steps and information about *why* the steps are performed, how they relate to each other, and so forth” (Bonner and Walker 1994: 159).

<sup>67</sup> Pierce and Sweeney (2005), however, also argue that the review process is just part of image management and justification in case of litigation, and that audit partners have other sources for their “audit comfort” when signing off (2005: 340).

as they know them. Subordinates better knowing the preferences and expectations of the reviewer, has been shown to have unintended adverse effects to the effectiveness of the audit review process, e.g., subordinates “stylizing” their work done and documentation to suit their manager (e.g., Johnson and Kaplan 1991; Lord 1992; Koonce et al. 1995; Gibbins and Trotman 2002). Overall, team work and the review and consultation processes are important for audit firm socialization and in relation to quality controls for engagement performance, in line with, e.g., ISA 220 on quality controls.

### 2.4.5 Communication and negotiation behavior

The significance of communication and auditor-client relationship to auditing can be seen in the very fundamental principles of the agency theory and in the profession’s Code of Ethics and independence principles. The assurance profession recognized the importance of two-way communication in auditing. ISA 260 (IFAC 2009b) provides guidance for the auditor’s communication with those charged with governance, including some specific matters to be communicated to them. The auditor-client relationship was also one of the main focal points of Sarbanes-Oxley that was intended to regain public trust (DeFond and Francis 2005: 14).

An auditor’s formal communication of the observations and findings generally has two forms:

- The auditor’s report or opinion “to the society at large” accompanying the client’s financial statements (reflecting the auditor’s conclusion on the financial statements based on the audit). The auditor’s report is a fairly standard communication based on the generally accepted text of the audit opinion as included in the auditing standards, i.e., this hardly reflects any specific behavior, other than reflecting the outcome of the audit process.
- The auditor’s reporting to “those charges with governance”, i.e. management (board of directors) and the audit committee (or non-executive directors).

Of specific relevance to the effectiveness of the audit process and the quality of companies’ external financial reporting is the auditor-client negotiation process. So far the auditing practice has largely ignored that the effect of audit quality on the quality of the financial statements is *contingent upon* the discussions and negotiations between auditors and the client’s management in how they resolve important audit issues (as noted, for example, by Cohen et al. 2007; Brown and Wright 2008; McCracken et al. 2008).<sup>68</sup> The negotiation process refers to the final stages of the audit where the

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<sup>68</sup> It is therefore notable that audit quality as such has been the focus of several streams of research as well as the object of recent and substantial changes in audit regulation. However, in these studies it is oftentimes ignored what audit quality means for the quality of the associated company’s financial statements. “Auditor-client interactions are fundamental to preserving audit quality, as these interactions include negotiations over changes in the financial statements necessary for the auditor to provide an unqualified opinion” (Nelson and Tan 2005: 61).

auditor works with the client when forming the auditors’ financial reporting (correction) decisions before issuing the audit opinion. The two parties may encounter situations where their reporting goals are materially different. This conflict can compel the auditor and client to enter into formal or informal negotiations, comprising pre-negotiation decisions and negotiation tactics (Bame-Aldred and Kida 2007).<sup>69</sup>

The negotiation process is a game full of nuances and pitfalls, and this game is generally won by the client.<sup>70</sup> This includes the process of “shadow negotiations” where parties attempt to position each other with regard to their roles, the legitimacy of their positions, and their relative negotiating power.<sup>71</sup> Hatfield et al. (2008b), for example, show that the outcome of the negotiations (and, thus, quality of financial reporting) is already influenced by very common discussion variables such as the *order* and magnitude of potential adjustments discussed. Trotman et al. (2005) show that auditors benefit from considering the client perspective (empathy)<sup>72</sup> or playing “give-

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<sup>69</sup> Brown and Wright (2008) provide an overview of the auditor-client negotiation process. The negotiation process consists of three stages (based on Brown and Wright 2008): (a) the pre-negotiation phase entails planning for upcoming negotiations, which may include explicit consideration of the interests, options, alternatives, and goals of both parties involved; (b) the negotiation phase wherein the auditor and client (e.g., CFO or controller) implement their respective negotiation strategies and thereby exchange information and views during the actual negotiations; and (c) negotiation outcomes. Negotiation literature identifies five broad negotiation strategies: concessionary, contending, compromising, avoiding, and integrative. In the extreme, negotiations involving threats, tension, guarded or biased sharing of information, and a lack of trust can result in the termination or resignation of the auditor.

<sup>70</sup> The auditor generally sees the negotiation process as an additional fact finding exercise whereby the client provides them with further information in response to their arguments for an adjustment prior to the auditor making the final judgment (Trotman 2005: 185). The client, however, approaches conflict resolution very differently. Clients generally seem to be better equipped in the negotiation tactics. For example, Bame-Aldred and Kida (2007) show that clients were more flexible than auditors, better able to determine the auditor’s goals and limits, and more likely to use negotiation tactics (such as bid high/concede later and trade-off one reporting issue for another). Tan and Trotman (2007) give additional insight into how “the game” is played between a client and its auditor and that the client is better able to anticipate on this game. They show that CFOs’ counter-offers to the auditors’ proposed audit adjustments tend to be higher (i.e. more in favor of the client) when the auditor adopts a gradual or delayed concession strategy.

<sup>71</sup> Part of “how the game is played” are “shadow” negotiations. Gibbins, Salterio and McCracken studied the negotiation behavior from the perspective of the *actual* audit partner-CFO relationship in a series of studies (Gibbins et al. 2001; Gibbins et al. 2005; McCracken et al. 2008). These significantly impact the position of the auditor and his or her relationship with the client, and, hence, the effectiveness of the auditor’s decision process.<sup>71</sup> Strategic position goes as far as audit firms managing the assignment of partners to engagements based on CFO preferences and removing those partners who are in “poor” relationships, irrespective of why the relationship is considered by the CFO to be “poor” (McCracken et al. 2008). These “strategies” in turn feed the CFO’s power in the “shadow” negotiations.

<sup>72</sup> On the other hand, Hatfield et al. (2008a) show that the use of a reciprocity-based strategy does not affect the quality of financial statements (audit), but simply facilitates the process of posting significant items. They found in an experimental setup on different negotiation tactics that the end result was the same.



and-take”.<sup>73</sup> Negotiation processes and outcomes can, thus, serve to strengthen or damage the ongoing auditor-client relationship, which is important in establishing mutual trust, respect, likely future strategies, and information sharing. Furthermore, negotiated outcomes can set a precedent for future negotiations<sup>74</sup> or result in feelings of reciprocity that create expectations on the outcome of such negotiations (Nelson and Tan 2005). Others point out that an auditor's effectiveness depends on the existence and proper functioning of an audit committee (e.g., DeZoort et al. 2003a; Ng and Tan 2003; DeZoort et al. 2008) or the restrictiveness of accounting standards (e.g., Nelson et al. 2002; Ng and Tan 2003)<sup>75</sup>, but also on the auditor's manner and details of communication with and reporting to the audit committee (e.g., DeZoort et al. 2003b).

#### 2.4.6 Documentation and justification

Documentation and justification is grounded in the accountability principles of the assurance profession. Documentation is the basis for an auditor's justification<sup>76</sup> of judgments as part of his or her accountability to others (i.e., the requirement to justify one's judgments to others. “The auditor is required to prepare audit documentation sufficient to enable an experienced auditor, having no previous connection with the audit, to understand the significant professional judgments made in reaching conclusions on significant matters arising during the audit” (ISA 230.8). For example, working papers and other documentation are held as evidence in case of litigation to prove that the audit process was conducted in accordance with the auditing standards (e.g., Nelson and Tan 2005). Two forms of audit documentation are generally distinguished, where the basic audit procedures are the same:

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<sup>73</sup> Sanchez et al. (2007), for example, show that CFO's indicate greater willingness to record material adjustments when they are made aware that the auditor has already waived immaterial adjustments (and are more satisfied with and likely to retain the auditor).

<sup>74</sup> For example, the acceptance by the auditor of a revenue recognition method adopted by the client in the current year makes it difficult in the following year to argue that the method is not appropriate.

<sup>75</sup> Ng and Tan (2003), for example, found that auditors are less likely to allow aggressive reporting if there authoritative guidance exists for a more conservative position. Other behavioral traits (such as empathy or an auditor's incentives) influence an auditor's willingness to search for and go along with a client's preferred way of reporting: “In general, [past research] provides evidence that auditors are more likely to make correction decisions that favor their clients when the balance of auditors' incentives favor the client and when *some latitude exists* that enables the auditors to justify the client-favored treatment.” (Nelson and Tan 2005: 46, emphasis added). Nelson et al. (2002, 2003) provide evidence that the manner in which managers attempt aggressive accounting (e.g., earnings management) depends on the precision of relevant GAAP, and that auditors are most effective in thwarting management aggressiveness when there exists precise GAAP that precludes the managers' preferred reporting position. Nelson et al. (2002) show that auditors are less likely to adjust earnings management attempts which are structured with respect to precise standards. Trompeter (1994) found that differences in GAAP restrictiveness tend to have a larger effect on the correction decision of auditors who are compensated more according to local office revenues (hence, constraining an auditor's personal incentives). In conclusion, the restrictiveness of accounting standards has a significant effect on the professional behavior of auditors.

<sup>76</sup> “Justifying is the act of providing evidence to support one's judgments or decisions” (Peecher 1996). “Justification” refers to the documented output of this process of justification.

- Summary memos, that typically summarize the sample source and selection criteria, audit procedures performed, and conclusions reached without providing any details of the individual evidence items examined. Details relating to audit evidence often are provided only for exceptions noted.
- Detailed working papers – Auditors completing detailed audit work-papers not only examine source documents, but provide all of the specific information for each sample item examined (such as names, dates, amounts, etc.), procedures performed for each item, and results for each item.

Payne and Ramsay (2008) showed that documentation through detailed working papers contributes to audit effectiveness due to the deeper cognitive processing that this entails. They argue that deeper processing leads to better error detection, evidence evaluation, and memory (the latter being a critical precursor to the accuracy of audit judgments and decisions). Payne and Ramsay note that given the recent regulatory pressures on increased audit quality, audit firms have generally returned to using more detailed working papers.<sup>77</sup>

Other studies in auditing have examined how different types of documentation affect auditors’ judgments. Agoglia et al. (2003), for example, show that the type of audit documentation and justifications impact an auditor’s fraud likelihood judgments (both of the preparer and of the reviewer). Tan and Jamal (2006) have shown that “stylizing” efforts of subordinates to please the preferences of their managers drives documentation and affects the reviewers effectiveness. Koonce et al. (1995), as another example, have shown that auditors who expect a subsequent review document more justifications.

Documentation and justification includes making appropriate use of the electronic audit (filing) system. “Audit firms promote these systems as essential for facilitating and achieving high-quality financial statement audits” (Dowling 2009). Research shows, however, that the appropriate use of electronic audit systems by auditors is nowhere close to being automatic and depends on factors such as auditors’ attitude and system restrictiveness.<sup>78</sup>

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<sup>77</sup> Previously, auditing firms used a reduced level of documentation for certain audit tests in order to increase efficiency and reduce litigation risks. Such documentation often consisted of only a summary memo explaining overall procedures and findings; details relating to audit evidence often were provided only for exceptions noted. The alternative is to prepare a detailed workpaper listing the specifics of all items examined, procedures performed for each item, and results for each item (Payne and Ramsay 2008).

<sup>78</sup> As these audit systems can only be restrictive and prescriptive to a certain extent, given the application of these systems for many different client environments, “audit firms must accept, to some extent, the risk that auditors do not use their audit support system in the way the design team intended” (Dowling 2009). He finds that auditors generally use electronic audit system appropriately, but that inappropriate use is linked to normative pressure (team- and firm-level consensus on appropriation), external control (system restrictiveness and effectiveness of the audit review process), auditor attitude, and self-efficacy. “To manage this risk and achieve high-quality audits, audit firms need to implement strategies that promote the appropriate use of these systems” (Dowling 2009).

### 2.4.7 Dysfunctional behaviors

Dysfunctional behavior (also referred to as quality threatening behavior, reduced audit quality acts or deviant workplace behavior by other researchers) is defined as “any behavior by auditors which has the potential to adversely affect audit quality” (Sweeney and Pierce 2004). Bédard et al. (2008a) provide a good insight into the forms of dysfunctional behavior and the frequency of auditors’ indulgence in dysfunctional behavior:

Extant research examines the frequency of such QTB [quality threatening behavior] as collection of insufficient audit evidence, inadequate work paper (i.e., audit documentation) review, other violations of generally accepted auditing standards (GAAS), violations of generally accepted accounting principles (GAAP), failure to book material adjustments, truncating sample sizes, accepting doubtful evidence, relying on internal audit work of questionable quality, insufficient risk adjustment in audit procedure planning, false or premature sign-off, failure to do thorough research, and under-reporting of time. Across these studies, a surprisingly large proportion of auditors admit to engaging in QTB. For example, Kelley and Margheim (1990) report that 31 percent admit to doing less than “reasonable” work, and only 40 percent of the seniors surveyed by Otley and Pierce (1996) deny having prematurely signed off on an audit step.<sup>79</sup>

Jelinek and Jelinek (2008) associate “workplace stress” to be a significant factor resulting in “deviant workplace behavior”.<sup>80</sup> The additional workload as a consequence of SOX, for example, has been reported to lead audit staff to “cut corners” to get through the workload. They distinguish three forms of deviant workplace behavior (2008: 224), of which organizational deviant behavior, such as under-reporting of time (e.g., recording less hours in one’s time sheet than the number of hours actually worked) and premature sign-off (or “cutting corners”) has received maximum attention. However, given the increased notion of the audit staff being the face of the firm in attracting, retaining and building relationships with clients, there is an increased relevance for further research on the impact of deviant interpersonal behavior occurring between co-workers (e.g., spreading of rumors, blaming other team members for things gone wrong, or accepting credit for someone else’s work) and deviant front-line behavior (such as when employees air “dirty laundry” to clients about problems they are having with their organization, making the firm or a partner of the firm look bad to a client).<sup>81</sup>

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<sup>79</sup> In addition, Tan and Jamal (2006) point to strategic behavior, “stylization”, and perception management of audit work paper preparers.

<sup>80</sup> “Workplace behavior deviance” is the voluntary behavior of organizational member that violates significant organizational norms and, in doing so, threatens the well being of the organization and/or its members (Jelinek and Jelinek 2008).

<sup>81</sup> As audit firms increasingly expect their auditors to behave professionally while at the same time build relationships, and hence share information and feelings authentically that are more personal in nature as part of that relationship building, and clients test their audit firm’s integrity by expecting to see that they

Almer et al. (2005) further point at “shirking”, leading to dysfunctional behavior.<sup>82</sup> Shirking in an audit setting can include wide-ranging activities such as social loafing<sup>83</sup>, failure to fully engage in more complex thinking, and audit-quality reduction acts such as premature sign-off of an audit step and under-reporting of time. An interesting finding is that of Malone and Roberts (1996: 62)<sup>84</sup>, who found that “auditors who had progressed beyond the staff level had higher incidences [of dysfunctional] behaviors”, although others find a more nuanced picture.<sup>85</sup> Large client size and the presence of a fixed-fee audit contract were found to be most strongly associated with dysfunctional behavior of partners..

Among the most studied dysfunctional behaviors is under-reporting of time (e.g., Kelley and Seiler 1982; Kelley and Margheim 1990; Otley and Pierce 1996; Sweeney and Pierce 2006) and prematurely signing-off an audit step as completed without actually completing the necessary procedure (e.g., Alderman and Deitrick 1982; Margheim and Pany 1986; Raghunathan 1991). Otley and Pierce (1996) find that a majority of seniors report having been asked either directly or indirectly by their managers to under-report time, and more than one-third report that they responded to tight budgets by reducing the quality of audit work. Dirsmith and Covalski (1985: 155), had already earlier found: “While the formal policy for every office from which people were contacted was that “eating time” was strictly forbidden, the informal system noted that it is one way of demonstrating a commitment to the firm and also the client”. As much as 58% of respondents in the study of Raghunathan (1991) reported to have engaged in premature sign-offs at one time or the other.<sup>86</sup> Time

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treat their staff as well as (they say that) they treat their clients, more research efforts should be put on how to align and create consistency in the organizational and personal behavior of the “front-line” service providers.

<sup>82</sup> “Shirking includes any action by a member of a team that diverges from the interests of the team as a whole. Shirking includes not only culpable cheating, but also negligence, oversight, incapacity, and even honest mistakes. In other words, shirking is simply the inevitable consequence of bounded rationality and opportunism within agency relationships. Shirking is related to self-interest, risk-preferences, bounded rationality (i.e. individuals are limited in their ability to attend to all possible decision factors, thus decisions are made without consideration of complete knowledge), information asymmetry, perceived pressures, and ethical preferences” (Almer et al. 2005: 2-3).

<sup>83</sup> That is, the moral hazard resulting from less effort being exerted by individuals who work in teams because it is difficult to measure individual work effort.

<sup>84</sup> Malone and Roberts (1996) proposed a conceptual model explaining the drivers for dysfunctional behavior, being on personality characteristics (e.g., locus of control, type-A behavior of “hard driving”, need for achievement, self-esteem, etc.), professional characteristics (e.g., organizational commitment, intent to stay, etc.), quality control and review procedures, audit firm structure, and time budget pressure. Donnelly et al. (2003) furthermore point to dysfunctional behavior as a reaction to the environment (i.e., the control system, time pressure and supervisor style).

<sup>85</sup> Carcello et al. (1996) looking at (perceived) inappropriate behavior of audit partners did not find much dysfunctional behaviors at partner level. They did find that when partners exhibit deviant workplace behavior, this was related to inadequate working paper review. The dysfunctional behaviors that Carcello et al. (1996) hypothesized at partner level were gathering insufficient audit evidence, performing inadequate workpaper review, committing other GAAS violations, committing GAAP violation, and failing to insist that the client book material adjustments.

<sup>86</sup> Raghunathan (1991: 77), looking at *actual* premature sign-off behaviors (as opposed to perceived behaviors), found “premature sign-off, while not uncommon, do not appear to occur frequently; the

budget pressure is generally the most significant factor inducing under-reporting of time or premature sign-off (e.g., Alderman and Deitrick 1982; Kelley and Margheim 1990; McNair 1991: 638), which subsequently affects audit performance and a vicious circle (e.g., leading to poor personnel decisions, obscuring the need for budget revision and resulting in unrecognized time pressures on future audits).<sup>87</sup>

#### 2.4.8 Audit pricing and practice development

Although the behaviors of auditors while performing audit tasks is the focus of this study, the behaviors related to the broader functioning of the auditor should not be ignored. Such behaviors, which are inseparable from the auditor's functioning as a whole, comprise tasks such as people recruitment, development and training, relationship management, business development and audit pricing, and general practice development including identity management and socialization (e.g., Hooks et al. 1994). Wyatt (2004) and Barret et al. (2005) note that practice development and other managerial skills have become relatively more important, while technical skills are relatively less important (e.g., rainmakers and effective client relationship partners are highly valued). The "business of auditing" increasingly focuses on financial results and an auditor's ability to maximize the profitability of an individual audit or account (e.g., McNair 1991; Cohen and Trompeter 1998; Wyatt 2004). Relationship management is important as part of distinguishing the audit service to clients (e.g., Alvesson 2004) and for making and developing contacts (e.g., Hooks et al. 1994).<sup>88</sup> Account and portfolio management is an inseparable aspect of relationship management and an auditor's daily work, during which "auditors assess financial risk, audit risk and auditor business risk, and consider whether engagement fees are sufficient to cover current and future expected engagement costs" (Johnstone and Bédard 2004).<sup>89</sup> I want to lift out two behaviors that are specifically relevant to auditing: (a) audit pricing and business development, and (b) activities in relation to practice management. These are discussed in more detail below.

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most commonly quoted reasons (...) are the auditor's belief that the audit step is not essential (low risk), followed by time limitations; and that seniors appear to be the group most likely to sign-off prematurely (...) and because of time limitations more often than do the other levels of audit personnel". They conclude that although the magnitude of premature sign-off behavior is not significant, the problem does exist and should be addressed given the effect it can have on audit quality.

<sup>87</sup> Bédard et al. (2008b) found that prior year negative budget variance and fee pressure resulted in audit team decreasing its reported audit hours. Furthermore, they found that engagement teams respond to imposed budget pressure also by reducing reported hours. Ettredge et al. (2008) find that engagement teams' reported hours also vary asymmetrically with prior budget variance.

<sup>88</sup> Hooks et al. (1994) found that audit partners ranked client referrals and recommendations as the most important practice development source, followed by referrals from within their own firms, former colleagues and business contacts, and their reputation for expertise.

<sup>89</sup> They show, for example, that audit firms are removing the riskier clients from their portfolios as the results of risk avoidance that the firms use to purposefully manage their client portfolios.

### ***2.4.8.1 Audit pricing and business development***

The basic principle of audit pricing is fairly simple, as Hayes et al. illustrate (2005: 86):

Professional fees should be a fair reflection of the value of the professional service performed for the client, taking into account the skill and knowledge required, the level of training and experience of the persons performing the service, the time necessary for the services and the degree of responsibility that performing those services entail.

Apart from this general notion on audit fee calculation, auditors apply different pricing strategies, among which fee-cutting or “low-balling” (e.g., DeAngelo 1981a), charging Big 4 or industry expertise “fee-premiums” (e.g., Simunic 1980)<sup>90</sup> and charging “risk premia” (e.g., Johnstone and Bédard 2001). The academic evidence, however, is mixed on the existence and magnitude, and their impact on audit effectiveness, of “Big 4 premiums” (e.g., Choi et al. 2008) and “low-balling” (e.g., Dopuch and King 1996). And although “low-balling” or bidding an audit at a minimum cost is discouraged by most professional organizations, it is commonplace in practice (e.g., Hayes et al. 2005).

DeAngelo (1981a) was one of the first accounting researchers to point out that competitive pressures were causing large public accounting firms to “low-ball” their initial fee structures to obtain audit clients. McNair (1991: 637) referred to the core audit as being a “loss leader”, which “investment” should be earned back through the provision of additional consulting services. This provision of non-audit services next to audit services (i.e., “cross-selling”) has been a much debated issue considered to impact audit pricing and independence of auditors.<sup>91</sup> Francis, for example, argues that “a case can be made that audit quality will always be somewhat suspect if other services are provided that are perceived to potentially compromise the auditor’s objectivity and skepticism” (Francis 2004: 345).

Fee pressure in auditing continues to increase due to difficulties that audit firm management experiences in getting the level of fees needed to cover the cost to achieve an acceptable level of audit quality. Competition, leading to reduced prices (and, thus, fee pressure), therefore, continues to be a particular worry of the auditing standards setters and supervisory institutions who state that the effects of competition

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<sup>90</sup> A fee premium associated with audits performed by Big 4. Craswell et al. (1995) not only report an audit fee premium for the Big 4 name, but also an audit fee premium for audit specialization within the Big 4.

<sup>91</sup> Research on the impact on independence of the combination of providing non-audit services (i.e. consulting or management advisory services) by the incumbent auditor goes back as far as the landmark research of Simunic (1984). The essence of this discussion can be found in what Arthur Levitt, the then Chairman of the Securities Exchange Commission of the US, said in May 2000 (quoted in Dopuch et al. 2001: 95): “The audit is sometimes priced lower to attract clients willing to pay for higher margin consulting services. (...) I’m concerned that the audit function is simply being used as a springboard to more lucrative consulting services”.

may not apply in the market of auditing services (Johnstone et al. 2004) as they fear that quality is sacrificed for business reasons (McNair's "cost/quality" dilemma).<sup>92</sup>

#### ***2.4.8.2 Activities related to general practice management***

Accounting firms are mostly organized as professional partnerships. The nature of how such a partnership is managed is characterized, among other things, by a fairly high degree of autonomy and the downplaying of organizational hierarchy. Covalleski et al. (1998: 293), in their ethnographic study comprising in-depth interviews with 180 auditors over a period of 15 years within the (then) Big 6 audit firms, found that auditors exercise a high degree of professional judgment in solving complex issues and that "professional-bureaucratic" conflicts arise given this autonomy. Organizational hierarchical structures, for example, are oftentimes sidestepped by "rainmakers" or knowledge-based authority, involving a high degree of self-determination. In the audit firm partnerships, strategic direction and decision-making is weak and dominated by negotiation, consensus building, and iteration. Greenwood et al., for example, note that "[i]mplementing a strategic decision depends on widespread acceptance and professional conviction rather than on corporate manipulation of resources, rewards, and sanctions" (Greenwood et al. 1990: 750).<sup>93</sup>

Consequently, next to the more traditional management control measures used by auditors in practice, such as "management by objectives" (e.g., revenue growth, realization rates, etc.), mentoring, and compensation-reward systems (Covalleski et al. 1998; Jenkins et al. 2008), management of a professional partnership generally comes down to using a number of "socializations themes" (e.g., Maister 1993; Lowendahl 1997; Alvesson 2004; Pierce and Sweeney 2005), such as clan controls (e.g., Ouchi 1980)<sup>94</sup>, reinforcing common beliefs and values<sup>95</sup>, and working with a strong client

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<sup>92</sup> Houston (1999) showed that fee pressure due to reduced audit fees leads to audit budgeting that is less responsive to audit risks (i.e., the risk that not all risks are appropriately covered). Gramling (1999), for example, found that auditors who are confronted with fee pressure due to clients with a low audit fee preference are more likely to rely on internal audit work of questionable quality (which is considered a "quality-threatening behavior") (from Hooks et al. 1994).

<sup>93</sup> The following quote by a senior managing partner illustrates the tension between the managing partners and other partners very well (Covalleski et al. 1998: 316): "Progress and the accomplishment of what we are trying to accomplish has a price. The price is for existing partners to give up some of their control, power and freedom for the greater good. On balance they tend to resist doing this. The one area that constantly plagues me in my day-to-day management is the difficulty in managing a business composed of owners, professional prima donnas, if you like-where everything involves strong consensus building".

<sup>94</sup> In their interviews of Big 4 audit partners, Pierce and Sweeney (2005) report that these clan controls are used extensively in large international accounting firms. As summarized in Jenkins et al. (2008: 53), "In Addition to formalized controls instituted through audit methodology and operating procedures, less formal clan controls based on experience and intuition are widely used to monitor the performance of subordinates and ensure audit quality (...) [which] allow highly experienced individuals (e.g., managers and partners) another avenue to exercise their power". "Under a clan control system, performance evaluation is a continuous process of subtle signals from old-time members" (Pierce and Sweeney 2005: 343 quoting Macintosh 1985).

orientation (e.g., Anderson-Gough et al. 2000).<sup>96</sup> Such socialization measures are not only used at lower levels of audit staff<sup>97</sup>, but also as “peer pressure” at the partner level (e.g., Covaleski et al. 1998)<sup>98</sup>, which then lead to everyday behaviors of meeting the social pressure and managing perceptions.

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<sup>95</sup> This would include the broad influence of partners on the firm’s culture through image management and informal communications, or even acknowledging the use of “partners” “sixth sense” or “intuition” (Pierce and Sweeney 2005: 358).

<sup>96</sup> These “client controls” range from explicit client demands, internally emphasized client orientations (including client satisfaction reviews) to the “image” of a client reflected in the organizational culture. Illustrating the latter, Anderson-Gough et al. (2000: 1171) showed how trainees in a large accountancy firm not only respond to specific clients or base their judgment on real-life encounters, but invent ideas of the client which then become true, at least in terms of control effect where this notion had “an abstract and symbolic significance when invoked to justify general requirements of behavior”.

<sup>97</sup> As one employee in an accounting firm observed in the study of Covaleski et al. (1998: 317) that his “emerging identity of being ‘chargeable’ was less associated with possessing expertise and wielding knowledge than with managing business relations with clients”. This leads to (a) incentives for certain behavior to *meet* the socialization pressures, e.g., an ambition to shape perceptions and the need to “keep up appearances”; (b) certain behavior to *manage* the socialization pressures through others’ perceptions of you (e.g., strategic behavior of subordinates in relation to their performance appraisals); and (c) an end result or performance “based on” that behavior (i.e. *perceived* performance). Managing that the gap between perceived *performance* and *actual* performance is not becoming too big, is then becoming an everyday behavior (“managing expectations”).

<sup>98</sup> That socialization is not only relevant at lower levels of audit staff and does not stop at partner-level, it can well be illustrated by the following quote of a regional managing partner interviewed by Covaleski et al. (1998: 311): “When we have monthly sales meetings with all the partners, each partner has sales goals and targets. And every month we have a report that comes out, (...) it’s got it by partner’s name, and it shows what he did last year, what he did year to date last year, and what his plan is for this year. Every month he sees the peer pressure because he’s got to get up (...), and he’s got to explain [to fellow partners] why he’s behind or ahead of plan”.



## 2.5 National culture in the context of the drivers of professional behavior

*Individual behavior is motivated by one's desire for pleasure  
and avoidance of displeasure (egotistical hedonism)*

Thomas Hobbes (1588-1679) in House et al. (2004: 517)

### 2.5.1 What drives professional behavior? A conceptual framework

In the previous sections, I have illustrated how professional behavior, in general, and that of auditors in particular, is defined and used in this study. In this section, the question as to what drives such behavior is central, with the objective to put the potential effect of national culture on behavior into context and perspective.

In this section, I present a conceptual framework for the systematic explanation of the professional behavior of auditors. This framework builds on the theories and definition of professional behavior covered in § 2.2 and is extended based on a number of frameworks proposed within the behavioral study of accountants, such as that of Dillard and Ferris (1989)<sup>99</sup>, Schlachter (1990)<sup>100</sup>, Libby and Luft (1993)<sup>101</sup>, and Malone and Roberts (1996)<sup>102</sup>. With this conceptual framework, I try to capture, structure, and analyze our current academic understanding of the drivers of professional behavior of auditors.<sup>103</sup> This overview also provides a more generic

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<sup>99</sup> Dillard and Ferris (1989) present a model of individual work behaviors in professional accounting firms based on the attribution theory and the expectancy theory. In categorizing the variables that explain work behavior, they distinguish between demographic/physiological variables (which characterize the individual, e.g., mental ability and socio-cultural attributes), cognitive/psychological variables (which reside in the individual's mind, e.g., attitude, learning and experience, perception and attribution, personality and motivation), and environmental/organizational variables (which reside outside the individual and are typically related to the structure of the work environment, e.g., reward systems, performance evaluation, and organizational culture).

<sup>100</sup> Schlachter (1990) proposes a framework of perspectives or levels from which professional (ethical) behavior in public accounting practices could be analyzed. He proposes a two divisional model dividing the public accounting profession from the external environment. Within the profession of accounting, Schlachter identifies four "behavioral perspectives" which are: the individual, the local office, the multi-office firm and the professional institute. Factors from the external environment driving behavior are considered by Schlachter to be the interaction with clients, licensing bodies, related third parties, and regulatory bodies.

<sup>101</sup> Libby and Luft (1993) theorize that audit decision performance is a function of (cognitive) abilities, knowledge, environment, and motivation.

<sup>102</sup> Malone and Roberts (1996) propose a conceptual model for explaining the drivers for "dysfunctional" or deviant auditor's behavior. They refer to personality characteristics (e.g., locus of control, self-esteem, type-A behavior of "hard driving" or competitiveness, need for achievement, etc.), professional characteristics (e.g., organizational and professional commitment, and intent to stay), and what I would summarize as audit firm management controls such as quality control and review procedures, audit firm structure, and time budget pressure.

<sup>103</sup> Presenting a conceptual framework means that the framework touches upon many behavioral aspects known within professional and auditing research, rather than covering each behavioral factor in-depth. This level is considered sufficient in the beginning to understand the behavioral dimensions in auditing and presenting them to the audience of this study (Van Maanen 1988: 25). Needless to say this leads me to abstract from the full detail and complexity of the drivers of professional behavior in real life.

insight into the behavior of professionals and employees in their work environment. The following components or categories of drivers of behavior are distinguished and illustrated subsequently:

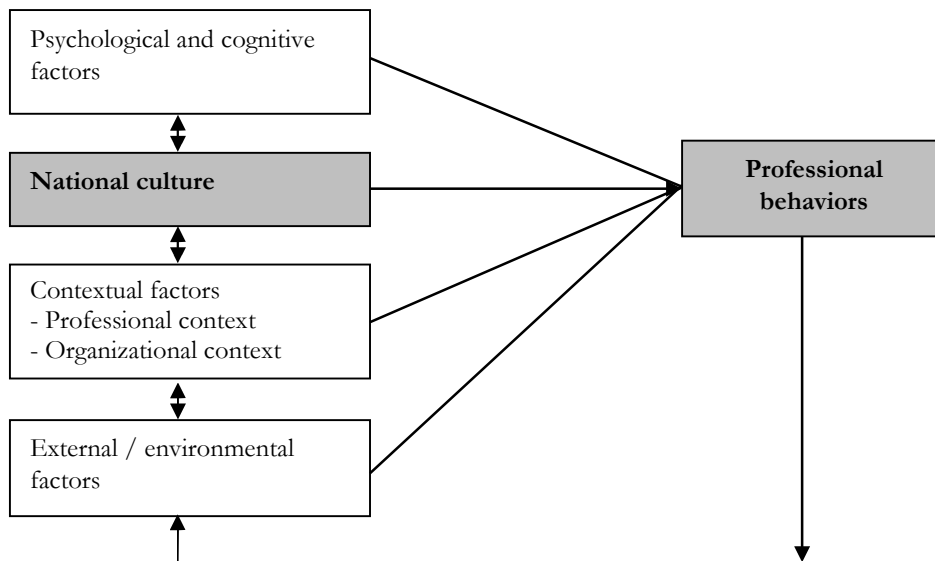


Figure 1 – The effect of national culture in the context of the drivers of professional behavior

These drivers are further illustrated as follows:

- **Psychological and cognitive factors:** Behavioral scientists generally agree that the primary factors responsible for variation in human behavior are the individual psychological and cognitive variables (e.g., Istvan 1973; Rhode et al. 1976; Dillard and Ferris 1989; Snead and Harrel 1991).<sup>104</sup> These not only comprise factors such as motivation, locus of control, moral reasoning, bounded rationality, but also the “basic human impulses” or “visceral traits” as the universal existential or “animal” reflexes such as fear, envy, greed, and other irresistible “desires” and self-interests (see § 2.5.2);
- **National cultural variables:** Poortinga (1992) notes that national culture places boundaries on human behavior by defining acceptable and unacceptable behavior. Apart from the national cultural variables as defined by House et al. (2004), covered in Chapter 3 of this thesis, these variables include the level of societal corruption and ethics (reference is made to § 2.5.3 and Chapter 3);

<sup>104</sup> Rhode et al. (1976), for example, found “biographical” and personality factors (such as parent’s education and occupation, religious preference, higher university grade point average, and extra-curricular activities) to differ between audit staff that left the firm within their first five years of employment and staff that remained working within the audit firm. Istvan (1973) found that partners were typically higher on dominance and extroversion and lower on passivity and conformity, in contrast to audit staff. Snead and Harrel (1991) find that personality, among others, affect senior auditors’ job satisfaction.

- **Contextual factors**, also referred to as the boundary and enforcement systems<sup>105</sup> (or lenses, constraints, choice alternatives, or Ajzen's normative beliefs) – the primary “appetite suppressants” (Alvesson 2002): “The fact that people act under different ‘constraints’, can often explain a great deal of variation in behavior” (Elster 2007: 6). These constraints mainly comprise the societal norms, values and beliefs within which an individual can choose his or her action. Next to national cultural variables, two “contextual factors” are distinguished in this study:
  - **Professional contextual variables:** Considering the professional culture is relevant because being a professional leads to certain behavior (e.g., protective behavior) or is the driver of behavior (e.g., social status and mobility). Barley and Kunda (2001) emphasize “the importance of an occupational perspective in organizational analysis”.<sup>106</sup> These variables comprise, for example, professional autonomy, codes of conduct and standards, accountability and oversight, education and knowledge, and nature and complexity of the task (see § 2.5.4).
  - **Organizational contextual variables:** Since auditors spend a large part of their working life in accounting firms, their professional attitudes are likely to be shaped by organizational culture and value systems. These variables comprise, for example, organizational image and socialization, management control, the employment relationship, audit approach and quality controls, and nature of the firm (see § 2.5.5).
- **External interaction and environment:** Personalities and cultures do not exist in isolation, but in the external interface with other actors or how we are seen and how we see others: “Although identities are constructed within organizations, organizational members are strongly influenced by their interaction with outsiders” (Alvesson and Kärreman 2007: 711). The effect can be seen in almost all behavioral theories covered earlier and is specifically relevant to the service industry and professional service firms.<sup>107</sup> With this factor I mean interaction with the environment *external* to the profession and professional<sup>108</sup>, such as clients, the

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<sup>105</sup> Jenkins et al. (2008) refer to this as “boundary-setting forces” which are the factors that guide and shape behavior and that provide legitimacy for (intended) behavior (hence, enforcement).

<sup>106</sup> “Accountants construct their identities and organize their practices not only around their employer of the market for their services, but also around their occupational affiliations” (Barley and Kunda 2004: 26).

<sup>107</sup> “By articulating the concept of emotional labor and its implications for customer, employers, and employees in a variety of occupation, [numerous scholars] forged the notion that service workers traffic in interaction” (Barley and Kunda 2001: 87). Professionals generally work in the service industry, thereby, providing professional service to others (in this case, mainly clients). Consequently, the interaction with others in the societal arena influences how auditors behave to a large extent. Interaction with others provides impulses, incentives, reflections, and boundaries of professional behavior. Also, Nelson and Tan (2005) refer to the interaction between auditor and other stakeholders as one of the three categories of judgment and decision-making in auditing (hence, behavior).

<sup>108</sup> Although many of the factors associated with national, occupational, and organizational culture are external to the person of the auditor as well, these factors are closely associated with the immediate

society at large, capital markets, etc., or rather the *interdependence with externalities* of professional behavior.<sup>109</sup> These factors comprise variables such as interaction with clients (including negotiation tactics), interaction with the society at large, and the litigiousness of the environment (see § 2.5.6).

- **Professional behavioral factors:** In this study as covered in § 2.4.

To reflect the multiple interactions and hierarchy between the constructs and the interdependence between intentions and actual behavior, the framework includes “*feedback loops*” connecting the components (consistent with, for example, Schlachter 1990).<sup>110</sup>

These variables and factors are further illustrated in the context of auditors’ professional behavior in the next subsections. A complete overview of the framework, detailing the underlying variables, is included in Appendix 1.

## 2.5.2 Psychological and cognitive drivers and limitations

Most of the factors under this heading are related to an individual’s personality, psychological cognition, and character. These comprise factors such as motivation (including reward), locus of control (e.g., Rotter 1966)<sup>111</sup> and confidence (e.g., Shanteau 1989: 2; Pincus 1991; Whitecotton 1996), moral reasoning (including ethics

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“being” of the auditor. That is, these cultural variables are considered to act primarily as “internalized” guiding principles for the auditor’s intended actions (i.e., before and regardless of the actual action), whereas the interaction variables are those influencing factors arising from the actual (inter)action of and with others (i.e., the responses of external factors that in itself influences or alters the behavior or auditors, which auditors adapt to).

<sup>109</sup> Hence, these factors could also be seen as outcomes or results of the behaviors, as Elster illustrates as well (2007: 300): “While actions are shaped by desires, they can also shape desires. Thus in addition to the intended outcome of an action, there is sometimes an unintended one: a change of desire”. In this study, these external factors are considered to shape the ultimate behavior. It could best be pictured as an intermediate force between *intended* and *ultimate* behavior, with an *a tempo* feedback loop between the two, consistent with Ajzen’s theory of planned behavior. However, this is not considered to add to the overall insight, clarity and understanding of the model. Hence, for ease of presentation, this feedback loop between intended and actual behavior, moderated by the external interactions, is not shown in the model. Nevertheless, I acknowledge that this is one of such simplification biases inherent to providing an overview.

<sup>110</sup> Schlachter (1990) also proposed a “feedback loop” between behavior (action) and the behavioral driver to reflect the interaction among them.

<sup>111</sup> Within auditing research, locus of control is mainly studied in relation to dysfunctional or “reduced audit quality” behavior. Malone and Roberts (1996), for example, argue that locus of control and self-esteem are two of the key personality characteristics in their model explaining dysfunctional behavior. Donnelly et al. (2003) evidenced that individual factors significantly affect dysfunctional behavior, such as external locus of control and lower levels of self-rated performance. Reed et al. (1994) have related locus of control to such behavioral matters as job satisfaction, organizational commitment and turnover intentions. Tsui and Gul (1996) found a relationship between external locus of control and an auditor’s ability to resist management pressure in audit conflict situations. Chan and Leung (2006) showed that “internals” are more likely to show an ability to recognize ethical issues than “externals”.

and risk appetite), bounded rationality (including biases and heuristics); or even mood states (e.g., Chung et al. 2005; Forgas and East 2008), but also the “basic human impulses” or “visceral traits” as the universal existential or “animal” reflexes such as fear, envy, greed, and other irresistible “desires” and self-interests.

Most of the challenges faced by the profession today are said to be related to personality characteristics (Haynes et al. 2008). Two personality traits that are considered to be of specific relevance today are emotional intelligence (or empathy and interpersonal relationship skills) and creativity.<sup>112</sup> Emotional intelligence has been found to have a positive influence on client relationships, management control, people development, and engagement quality (e.g., Power 2003; Barret et al. 2005; Pierce and Sweeney 2005; Trotman 2005).<sup>113</sup> Creativity has been associated with problem-solving abilities and decision-making, confidence and competitiveness, communication skills and achieving a “distinctive image in the marketplace”, and innovative and multi-competence thinking (e.g., Shanteau 1989; Hood and Koberg 1991; Al-Beraidi and Rickards 2003).<sup>114</sup>

Behavioral drivers that are considered specifically relevant and pervasive for the auditing context in relation to the subjective interpretation and application of the standards are:

- “Animal spirits” and motivation (including greed and reward);
- Moral reasoning;
- Bounded rationality (including biases and heuristics).

Below I discuss these three drivers in more detail.

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<sup>112</sup> As early as 1973, Istvan hinted at the relevance of “soft skills” to the future of the auditing profession (1973: 35): “Accountants by nature seem to be more data-oriented than people-oriented. This intrinsic facet of our profession is in conflict with our future professional needs”. But it still took a while for his conviction to find solid ground and to become recognized as significant and relevant by broader circles of accountants.

<sup>113</sup> Trotman et al. (2005) show that auditors benefit in auditor-client negotiations from being empathic and considering the client perspective. In their study on the partners’ perspective on management controls within an audit firm, Pierce and Sweeney noted that “Frequent reference was made to this sixth sense as an instinctive form of control, which was considered to be an essential quality for anyone wishing to gain admission to the partnership” (2005: 365). They refer to Power (2003) who suggested that hunch and intuition are extremely important elements in the conduct of an audit “such as knowing what questions to ask during the review by interview and knowing which audit merits additional review time”, which to a large extent depends on an auditors ability to read the “subtle signals” of the body language of their juniors. Interesting in relation to emotional intelligence and empathy is also the study of Haynes et al. (2008) of auditors’ *situational flexibility* in adopting different personality profiles “to address the skills required for the global business environment”. Where accounting students preferred “Myers-Briggs type indicator” dimensions of sensing, thinking and judging while at work, they adopted quite different personality profiles while socializing. In more social settings, auditors have been found to be able to utilize a much broader range of personality-related behaviors (such as intuition and feeling). This has led Haynes et al. (2008: 94) to suggest to change the auditing education to “encourages the use of such abilities, [rather than] recruiting different students, (...) to assist accountants bring forth those characteristics that are required by the profession as it seeks to change”.

<sup>114</sup> Hood and Koberg (1991) found partners in Big 4 firms to be more creative than audit staff, which is an interesting finding in light of the assumed business added value of the creativity trait.

### 2.5.2.1 “Animal spirits” and motivation (including greed and reward)

*The point is, ladies and gentlemen, that greed – for a lack of a better word – is good. Greed is right. Greed works. Greed clarifies, cuts through and captures the essence of the evolutionary spirit. Greed in all of its forms – greed for life, for money, for love, for knowledge – has marked upward surge of mankind.*

(Gordon Gekko, 1987, in “Wall Street”, who will – rumor has it – return after his imprisonment in “Wall Street 2” in 2010)

Freud referred to the authentic desire of the “id”, which Elster calls visceral traits and impulses: the “irresistible” desires, temptations, anxieties and other emotional, mental, or physiological ‘impulses’ and feelings that are so strong “as to crowd out all other considerations” (Elster 2007: 76). These impulses can be fear, pain, shame, thirst, hunger, envy, anger, greed, revenge, etc.. “They have the potential, not always realized, for blocking deliberation, trade-offs, and even choice” Elster continues.<sup>115</sup>

Akerlof and Shiller (2009) compare these impulses with “animal spirits” of the mind (2009: 4). They argue that the current financial crisis is caused precisely by these “animal spirits” – “confidence, fairness, corruption and antisocial behavior, money illusion, and stories” – among which “greed” is predominant.<sup>116</sup> And greed coincides with aspects such as self-interest and myopia: “[Self-]interest is the pursuit of personal advantage, be it money, fame, power, or salvation” (Elster 2007: 78).<sup>117</sup> Hence, humans will always want more and more as they are a “wanting animal” (Maslow 1943: 395).<sup>118</sup> This is what Partnoy (2003) called “infectious greed” when he analyzed how greed and deceit corrupted the financial markets. Wyatt points to corporate and individual greed also being present in the assurance profession.<sup>119</sup> These visceral traits

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<sup>115</sup> Elster (2007) paints the “caricature” of the rational agent in this picture as the opposite behavioral traits of these innate impulses. In between, Elster reasons, “we find behavior that is partly motivated by visceral factors, yet is also somewhat sensitive to costs-benefit considerations” such as strength of interest being neutralized by social conscious (e.g., guilt feelings).

<sup>116</sup> Akerlof and Shiller (2009: 29-38): “Each of the past three economic contradictions in the United States – the recession of July 1990 to March 1991, the recession of March to November 2001, and the recession that began in December 2007 – involved corruption scandals. Scandals played a role in determining the severity of each of these recessions. (...) All public corruptions involve the managing of other people’s money. There is therefore always the opportunity for the managers to pocket the money and run. (...) The business cycle is connected to fluctuations in personal commitment to principles of good behavior and to fluctuations in predatory activity [i.e., greed]”.

<sup>117</sup> Birnberg and Shields illustrate “self-interest” as a key feature sharply, as follows (1989: 29): “Individuals are motivated by self-interest. Moral hazard exists because contracts between principal and agent only can be made on observable variables. These usually are imperfect measures of actual behavior. Adverse selection points to the problem of information asymmetry between the principal and the agent. Individuals have private knowledge that is of value to the firm. Only under favorable conditions will the agent truthfully reveal it. In the formal model the agent is effort averse. Given a choice, the worker prefers leisure to effort and must be rewarded to make him or her work”.

<sup>118</sup> This is illustrated by Maslow’s further conclusion that “the hierarchy [of needs] principle is usually observed in terms of increasing percentages of non-satisfaction as we go up the hierarchy”, leading to the intriguing paradox of the more we get, the less satisfied we are with it, and the more we want even more.

<sup>119</sup> Wyatt (2004) points to corporate and individual greed as one of the main factors having tarnished the reputation of the auditing profession after the collapse of Arthur Andersen in 2002. While describing the

are, to such an extent, universally present at the personality level in humans of all kind, that auditors would not be expected to react differently to these impulses compared with any other human being. How exactly these innate human impulses affect auditors' behavior is food for future research.

Where basic human “impulses” are considered to be of a more unconscious, uncontrollable kind, motivations are those behavioral drivers that are more conscious (or rational to some extent).<sup>120</sup> Within the professional environment of auditing this is further analyzed, mainly by Dillard and Ferris (Ferris 1977; Dillard 1979; Ferris et al. 1980), through the Valence-Instrumentality-Expectancy theory paradigm of Vroom that was central in occupational behavioral sciences.<sup>121</sup> Other scholars have based their behavioral study on McClelland's trichotomy of need theory.<sup>122</sup> The theory's validity was demonstrated in a number of environments.<sup>123</sup>

Reward is one of the primary motives for action and efforts. If the reward is wanted badly enough, a person will initiate any action to obtain that reward. And it is this appreciation of the reward that differs between people – be it monetary rewards (i.e. money<sup>124</sup>) or non-monetary reward (such as status, prestige, recognition, or

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history of audit firms and their growing profitable consulting business on the side, Wyatt acknowledges that in retrospect it is easy to see the greed factor at work: “The consulting arms exerted increasing pressure for additional profit shares and for ever-increasing rates of growth. (...) Since the partnership form or organization did not permit the use of stock options, accounting firm partners had to grow firm revenues and profits in order to enjoy wealth increases like those of the top executives of their clients [who were enjoying stock option profits]” (Wyatt 2004: 49). Wyatt acknowledges that it is easy in retrospect, “at the time, however, the changing focus on revenue and profit growth was viewed as merely adapting to the changing times”. Nevertheless, “in essence, the cultures of the firms had gradually changed from a central emphasis on delivering professional services in a professional manner to an emphasis on growing revenues and profitability”.

<sup>120</sup> Motivations arise out of a more or less conscious weighing of effort, risk, and reward. Parson and Shils (1951) already account for motivation as the core of the “personality system of orientation”. Ferris and Larcker (1983: 2), in explaining variables of auditor performance in a large public accounting firm, note motivation as one of the primary determinants of work-related behavior. Lampe and Earnest (1984) view motivation as a key to accountants' productivity.

<sup>121</sup> According to Vroom (1964, as discussed in Ferris et al. 1980), motivation depends on the likelihood that effort will lead to the reward valued most as compensation for that effort. Instead of reward, one could also read a potential loss that one would want to prevent anxiously. Somewhat in line with Maslow's hierarchy of needs, Dillard and Ferris (1979) showed for example that “high job security” and “personal growth and development” were among the positive indicators for auditors not to leave the audit firm.

<sup>122</sup> McClelland (1961) suggested and validated this suggestions that the work behavior of most individuals is motivated by three needs – need for achievement (nAch), need for affiliation (nAff), and need for power (nP). He reasons that behaviors may differ due to motivational differences among individual, i.e., the individual involved has affiliation, power and achievement needs that differ as far as their share in motivating him or her goes.

<sup>123</sup> Harrel and Stahl (1984: 241) found, among others, that within the auditing profession “an individual's need for achievement was positive associated with his or her performance rating (...) and self-assessed work performance [and hence job satisfaction]”. Malone and Roberts (1996) suggest, among others, need for achievement as being one of the personality characteristics in their model explaining dysfunctional behavior (reduced audit quality behavior, see § 2.9.8).

<sup>124</sup> The current society-wide discussions (or rather outrage) about “excessive compensation and bonuses” is entirely focused on the monetary side of reward and motivation. Although money indeed makes the

personal development)<sup>125</sup>. Particularly when dealing with professionals, next to economic incentives, non-economic rewards also affect behavior. Jenkins et al. (2008: 60) conclude that the “limited research on organizational control and compensation/reward systems in audit firms suggest that these incentive structures affect partner and employee behavior”.

### 2.5.2.2 *Moral reasoning*

In the last two decades, and especially after the recent corporate accounting scandals (Cohen and Bennie 2006), much research attention has been given to the ethical or moral behavior of accountants (e.g., Ponemon and Gabhart 1990; Ponemon 1992a, 1992b; Shaub et al. 1993; Emanuels 1995; Jones et al. 2003).<sup>126</sup>

These psychological frameworks have mainly been based on Kohlberg’s theory (1964) of moral cognition.<sup>127</sup> Three stages of morality are distinguished — personal interest, maintaining (social) norms, and post-conventional sophistication of ethical reasoning.<sup>128</sup> Although research of the Jones model of “moral intensity” (Jones 1991) within auditing is yet fairly limited, the work of Cohen and Bennie is quite noteworthy, especially given the considered explanatory power of the model. “Different situations will elicit moral intensity factor ‘weightings’ that change, depending on the situation and context of the moral issue” (Cohen and Bennie 2006: 2). These “weightings” differ from person to person, and are (based on Cohen and Bennie 2006):

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world go round, this discussion is, therefore, limited and one-sided. Many non-pecuniary rewards can play an evenly, if not bigger, defining role in driving human action. Fraudulent behaviors in cases such as Enron and Ahold were much more about personal status, power, and recognition than about money only. Nevertheless, compensation, especially the variable bonus part of it, incentivizes certain behaviors. As in banking, where certain compensation and bonus schemes triggered excessive risk taking (Economist 16 May 2009), incentives and bonuses also encourages certain behavior (e.g. being commercially driver) or discourage other behavior (e.g. how much of a partner’s reward is depending on quality review results). Becoming a partner may not seldom depend on ones commercial contribution to the money pit, rather than ones capabilities of doing a quality audit.

<sup>125</sup> Almer et al. (2005) refer to both pecuniary rewards (salary and benefits) and non-pecuniary rewards (e.g. development, flexibility and autonomy, deferred compensation in anticipation of future partnership in the firm) as factors in the compensation received by the auditor. In any profession altruism, for example, should be seen as rewards, adding to the professional’s status, affiliation or belonging.

<sup>126</sup> Scholars in this field attempt to unravel and evaluate factors affecting that ethical behavior. These studies incorporate or expressly consider a psychological framework for the ethical reasoning process and, generally, find a strong relationship between auditors’ moral development and his/her judgment and decision-making.

<sup>127</sup> Kohlberg states that human moral reasoning is developed in a series of overlapping stages during a human’s life (starting with childhood), with higher-level moral schemas gradually gaining and lower-level schemas gradually declining. “Imaginatively putting oneself in the place of another, or social perspective taking, is central to moral development and behavior. It relates to the right and the good of morality, that is, to justice or mutual respect and to empathy or caring” (Gibbs 2003: 1). “It is about the problem solving strategies and cognitive structures people use to guide their moral decision-making, make sense of the world, and construct meaning” (Rest et al. 1999: 17).

<sup>128</sup> This is documented and made measurable, among others, using Rest’s (1979) “Defining Issues Test”. Tsui and Gul (1996), for example, applied this test to measure ethical reasoning of auditors in conflict situations.



- Magnitude of the consequences, i.e., the sum of harms and benefits resulting from a given action;
- Social consensus, i.e., the extent of agreement that an action is ethical or unethical;
- Probability of effect, i.e., the likelihood of consequences actually occurring;
- Temporal immediacy, i.e., the length of time between the action and the onset of the consequence;
- Proximity, i.e., the affinity with the victim or beneficiary; and
- Concentration of effect, i.e., the function of the number of people affected.

Coram et al. (2008) provided support for the Jones model in the context of an audit by showing that the “moral intensity” varies over different moral issues of “reduced audit quality” behaviors, and hence, is issue-contingent.

The most important factor within the auditing context is the magnitude of the consequences, followed by social consensus and probability of effect (Cohen and Bennie 2006: 14). In other words, auditors’ moral reasoning is the “weighting” of the potential reward versus the risk of getting caught. Noteworthy is that scholars have shown that the intrinsic moral reasoning of auditors may not be any “higher” than the average professional (e.g., Emanuels 1995; Schatzberg et al. 2005) and lower than that could be expected of auditors based on their professional qualifications (Emanuels 1995). In their study of how both economic incentives and moral reasoning influence auditor reporting, Schatzberg et al. (2005) find that auditors’ appropriate reporting behavior is positively affected by moral reasoning, but negatively by economic incentives. However, they also find that the effect of economic incentives diminishes when economic penalties increase in the market. In other words, supervision (i.e., the risk of getting caught in combination with sufficiently large economic or social penalties) is an effective or even necessary measure to uphold auditors’ moral reasoning (and, thus, compliance with conventional norms).

Furthermore, “[r]esearchers have found that ethical behavior is significantly influenced by the other people that an individual encounters in a professional environment” (Shaub et al. 1993: 147). Moral reasoning is strongly influenced by the social surroundings of an auditor. Specifically interesting is the study of Lord and DeZoort (2001), who investigated two forms of social influence pressure on auditors’ moral reasoning: obedience pressure (from commands made by superiors) and conformity pressure (from examples set by peers). They show that obedience pressure (and peer pressure not) increased auditors’ willingness to sign-off on materially misstated financial statements. Social pressure from “above” (but not from “peers”) has, thus, a strong and significant effect on the ethical decision-making behavior of auditors.

### ***2.5.2.3 Bounded rationality (including biases and heuristics)***

Like every human being, an auditor’s judgment and decision-making process is faulty and highly prone to a number of cognitive limitations (judgmental biases) and generalizations (heuristics or “rules of thumb”). In auditing research, much interest goes out to whether auditors are cognitively limited and susceptible to heuristics and

biases described in the psychology literature (Shanteau 1989), most notably those identified by Tversky and Kahneman (1974):

- *Anchoring and adjustment heuristic*: Auditors focus on an initial value (i.e., anchor) in the decision setting and, based on the available information, adjust from that value to arrive at a judgment. The issue here is that adjustments from the anchor are generally insufficient, meaning that the starting point is highly relevant in reaching the ultimate judgment (which then is biased toward the starting point). For example, anchoring behavior has been shown to give undue credence to client representations in analytical procedures (Kinney and Uecker 1982) when auditors “anchor” on client-provided information in the expectation formation.<sup>129</sup>
- *Representativeness heuristic*: Auditors assess the probability that an item or event is similar to others based on commonalities. More representative events are judged to occur more often or to be more probable, i.e. the unexpected (e.g., “black swans”) is least considered, although it could well be the explanation for a given issue. This heuristic relates to biases such as stereotyping (neglecting the base rate) and the use of fallible evidence (based on a disregard of the source reliability or sample size).<sup>130</sup>
- *Confirmatory bias*: The auditor is naturally inclined to attend to evidence that confirms the hypothesis being tested (i.e., the expected or preferred outcome) as opposed to information that disconfirms the expected outcome. People generally and pervasively engage in confirmatory strategies when searching for information (“information-search bias”) and when retrieving information from memory (“biased recall”), and regard confirming evidence as more informative (i.e., stronger). Glover et al. (2005), for example, provide evidence that “auditors attribute more strength to a weak, aggregate-level analytical procedure that creates

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<sup>129</sup> “Auditing has been characterized as a *sequential* process of obtaining and evaluating evidence. During this process auditors continuously update their beliefs about the audit assertion being examined” (Tubbs et al. 1990). Ashton and Ashton (1988) and Tubbs et al. (1990: 452) provide evidence that auditors exhibit “recency effects” consistent with the “belief-adjustment model” that Hogarth and Einhorn developed in the 1980s and further evidenced (Hogarth and Einhorn 1992). This model posits that people update beliefs using a sequential anchoring and adjustment process. Kennedy (1993) notes that “end of sequence” tasks are more cognitively demanding (than step-by-step) because it requires an individual to aggregate evidence before integrating it with an “anchor”. Further studies have shown that the recency effect is mitigated by experience, the review process and accountability (Nelson and Tan 2005).

<sup>130</sup> That cognitive limitations, such as the representative heuristic, can have a far reaching impact and can be illustrated by the study of Joe (2003) who shows that even press coverage of a client influences the audit opinion. This is evidenced through the “dilution bias” that auditors are susceptible to (Hackenbrack 1992). A dilution effect is said to occur when judgments made in the presence of both diagnostic (relevant to the case) and non-diagnostic (not audit relevant) information are less extreme than those made only in the presence of diagnostic information (Nisbett et al. 1981). It was further found that time pressure and accountability eliminate the dilution effect, and that experience mitigates this bias through the review process (Nelson and Tan 2005), all of which seems logical from an efficiency perspective.

an expectation that is not significantly different from the unaudited number (i.e., “favorable” outcome)”.<sup>131</sup>

Bazerman et al. (2002) pointed to the auditing’s vulnerability to unconscious bias as the real problem why good accountants do bad audits. This would be primarily related to the client relationship, self-serving bias, and independence.<sup>132</sup> They argue that auditors will consciously and opportunistically misuse bias to facilitate themselves.<sup>133</sup> Moore et al. (2006) posit a more forgiving take on auditors’ intentional misuse of bias. They argue that the current independence regulations have created “an environment in which auditor independence is virtually impossible” (2006: 15) as these regulations ignore “the structural features of the auditor-client relationship that create conflicts of interest”. These conflicts of interest, in turn, affect auditor judgment *unconsciously*, Moore et al. reason. This *unconscious bias* would be far more pervasive:

Evidence on unconscious bias suggests that people are not very good at disregarding their own self-interest and evaluating information impartially, even when they try to do so. (...) People justify self-serving decisions by using the arguments that happen to favor them, without awareness of this selectivity. (...) People appear to evaluate evidence in a selective fashion when they have a stake in reaching a particular conclusion [and] research has shown that professionals are vulnerable to the same motivated biases as laypeople (Moore et al. 2006: 16-17).<sup>134</sup>

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<sup>131</sup> Confirmation bias can also be seen in between-auditor interaction for example. Attribution theory posits that individuals do not react directly to the behavior of others, but first go through an intermediate process of attributing behavior to its cause (Birnberg et al. 1977; Shields et al. 1981). Once these attributions are formed, they affect the subsequent behavior of the individual toward the target person. “Work style similarity” and “Personal liking”, for example, are attribution mechanisms evidenced to impact performance evaluations, what can be explained by “similarity-attractions”: “Similarity-attraction theory describes a situation in which individuals tend to like others who are similar to themselves. This is based on the argument that people evaluate their own opinions, abilities, and behaviors by comparison with those of others. By evaluating oneself against other who are similar, an individual’s self-concept is increased” (Xu and Tuttle 2005: 195). “Attribution theory focuses on the interpretation of behavior or stimuli rather than on the acquisition or production of information” (Dillard and Ferris 1989: 211).

<sup>132</sup> Bazerman et al. argue that “calls for auditor independence implicitly adopt a naïve, unrealistic model of auditor psychology” (1997: 91). They point out that although the profession’s Code of Ethics “acknowledges the pressures on the integrity and objectivity of the auditor, but contends that auditors can achieve a level of independence [i.e. accountability]”, however, that “auditors may find it psychological impossible to remain impartial and objective” (1997: 89). They explain, based on a number of experiments, that, “in sum, auditors’ judgments are likely to be biased in favor of their own and their client’s interests. This bias occurs indirectly as a result of selective sifting and integrating audit information. As a result, the bias is likely to be unintentional and impervious to moral suasion or the threat of delayed and probabilistic sanctions [i.e. accountability], which are likely to seem quite remote”.

<sup>133</sup> Bazerman et al. (2002: 98) elaborate that bias will thrive “wherever there is the possibility of interpreting information in different ways” (ambiguity), wherever the auditor has “strong business reasons to remain in clients’ good graces” (attachment), and “when people are endorsing others’ biased judgments” as an audit ultimately endorses or rejects the client’s accounting rather than taking an own independent stance (approval).

<sup>134</sup> Moore et al. (2006: 17) point also to “plausible deniability” and “escalation of commitment”, meaning that “when it comes to biased judgments, evidence suggests that people are more willing to endorse a

Bazerman et al. (2002) acknowledge these more innocent but pervasive human traits, and thus that these are intrinsic to human behavior, but nevertheless call for radical measures in an effort to control these unconscious traits.<sup>135</sup>

### 2.5.3 National cultural variables

The nine dimensions of nation culture guiding the behavior of people that House et al. (2004) developed in their GLOBE study will be the frame of reference from this study. These cultural dimensions are:

- Power Distance
- Uncertainty Avoidance
- Humane Orientation
- Institutional Collectivism
- In-Group Collectivism
- Assertiveness
- Gender Egalitarianism
- Future Orientation
- Performance Orientation.

These cross-national cultural dimensions, and their impact on behavior in general, are covered in *Chapter 3* on cross-national cultural differences.

These dimensions reflect the societal cultural variables, except for one societal factor that is of specific relevance to auditing: the societal acceptance of corruption or the level of societal ethics. Kimbro (2002: 332) poses that “individuals will consciously or unconsciously consider the moral cost of becoming involved in corrupt activity. (...) The private morality aspect is related to the value system of the society”. House et al. (2004: 558) have related corruption with cultural power distance (i.e., hierarchical and pyramidal societies) and collectivistic values, under which unequal power relations are valued, meaning that corrupt behavior would be legitimated as a privilege of position. This would mean that auditors in countries with collectivistic values and high Power Distance generally may be confronted with higher fraud risks at their clients. It is noteworthy that Kimbro (2002), on the contrary, found that for the generally stable

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biased proposal made by someone else than to make one on their own” and “that people tend to escalate their commitment to a previous course of action, [meaning that] moral seduction occurs one step at a time [and] that ethical lapses are more likely to occur gradually” where auditors feel compelled to justify the previous year’s (unjustified) decision. Both mechanisms can be well identified in the behavior and decision-making of auditors, as indicated above.

<sup>135</sup> Bazerman et al. (2002: 102) conclude to suggest a number of “radical remedies” to “eliminate incentives that create self-serving biases”, from “fixed, limited contract periods during which the auditor cannot be terminated (...) and the client must be prohibited from rehiring the audit firm at the end of the contract” to more pragmatic suggestions for education as “auditors must come to appreciate the profound impact of self-serving biases on judgment”. Although provocative to some extent, one can recognize certain aspects of their reasoning in the auditors international code of ethics.

and wealthy countries with well developed financial and accounting systems, it is the individualistic cultural dimension of a country that leads to higher corruption, which may be bourn on such factors as greed and self-indulgence.

Cross-national differences in the contextual (professional and organizational) and environmental variables of the framework are considered “culture-free” contingency-based differences.<sup>136</sup> Although cross-national cultural differences in these factors are influencing auditors’ behavior *indirectly*<sup>137</sup>, they will not be further covered in this thesis in a structured fashion (i.e., only when specifically relevant to our understanding). This theoretical review also excludes the cultural impact on the psychological/cognitive variables of the framework of auditors’ behavior. In general, these are considered to be universal traits, i.e., not culture specific.<sup>138</sup> Rather, a *direct* culturally grounded anthropological approach (Chanchani and MacGregor 1999) is taken, as this study focuses on the cross-national cultures in explaining differences in auditors’ professional behavior. This will be further covered in *Chapter 3* of this thesis.

#### 2.5.4 Professional contextual variables

The professional contextual variables comprise the more professional “boundary-setting forces” (Jenkins et al. 2008) such as the code of professional conduct and ethics; auditing standards and compliance; education, knowledge, experience, and (problem-solving) ability (e.g., Bonner and Lewis 1990; Libby and Frederick 1990; Bédard and Chi 1993; Libby and Tan 1994; Tan and Kao 1999)<sup>139</sup>; and public accountability and supervision (e.g., Lord 1992; Kennedy 1993; Libby and Luft 1993)<sup>140</sup>. It also entails factors such as professional autonomy and commitment (e.g., Aranya and Ferris 1983; Barley and Kunda 2004: 26; Smith and Hall 2008)<sup>141</sup>;

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<sup>136</sup> In the contingency approach the researcher attempts to find variables that would explain variation among countries, which are considered ‘culture-free’ and neglecting the human agency (Saudagaran and Diga 1999).

<sup>137</sup> The relationship between these forces and a country’s culture, socialization, institutions and enacted behaviors, are so intertwined that they cannot be easily isolated. Important to note is that the cross-national differences in these occupational, organizational and interactional variables of the conceptual framework can thus also be *confounding* factors interfering in a causal or contextual relationship between cross-national *cultural* differences and auditors’ professional behavior.

<sup>138</sup> In cross-cultural research a general distinction is made between *etic* (universal) and *emic* (cultural-specific). Emics are ideas, behaviors, items and concepts that are culture specific. Etics are ideas, behaviors, items, and concepts that are culture general, i.e., universal (Triandis 1994; Smith and Bond 1998). Etics would be the basis human traits and spirits such as envy, greed, fear, aggression, emotions, et cetera.

<sup>139</sup> For example, Brown and Johnstone (2004) observe that more experienced auditors are more skeptical in their approach to negotiation (e.g., offering fewer bids and fewer monetary concessions), and that this approach pays off by giving higher satisfaction with negotiation outcome. Moreover, they observe that less experienced auditors are more likely to concede when facing a high-risk engagement (who presumably will be more persuasive). Kaplan et al. (2008) have shown that audit seniors with more experience are less inclined to go along with (favorable) management’s assessments and conclude that “as auditors gain experience, they also gain persuasive knowledge, which allows them to deflect management’s persuasion attempts”.

<sup>140</sup> Accountability is defined as “the existence of social pressure to justify one’s judgments to significant others” (Tetlock 1983: 285) and has been found to translate into better audit performance and to

job complexity and ambiguity (e.g., Pincus 1990; Bonner 1994; Abdolmohammadi 1999; Zimbelman and Waller 1999); and profession-related job stress.

Behavioral drivers in the context of the profession that are considered specifically relevant and pervasive for the auditing context in relation to the subjective interpretation and application of the standards are:

- The effect of auditing standards on behavior (rules versus principles-based); and
- Recent aggravators increasing professional workplace stress and consequently, deviant behavior.

These two drivers are discussed in more detail below.

#### ***2.5.4.1 Auditing standards (rules versus principles-based)***

The IFAC sets, among others, international auditing and assurance standards and a code of ethics for professional accountants. These standards are so-called “principles-based”, which means that the nature of the international standards is such that it required auditors to exercise professional judgment in applying them. This is recently emphasized by the IFAC itself, which recently called to embrace issues in spirit rather than in letter (IFAC 29 March 2009), setting the already principles-based standards open for multiple interpretation.

Nevertheless, an increased compliance and rules-based wind has been blowing in recent years. For example, Moore et al. point to the increased focus in auditing on compliance to the rules, rather than adhering to the underlying principle as an example of the widespread “shift in corporate ethics, from a focus on what is morally right to a focus on what is technically legal” (Moore et al. 2006: 13). Others have argued that this over-emphasis on compliance leads to “ticking the box” behavior and an intellectual drain of the profession (Jelinek and Jelinek 2008).<sup>142</sup> Ticking the box

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improve judgment consistency and agreement within the audit team (“consensus”) (e.g., Kennedy 1993: 231; Almer et al. 2005: 7). Lord (1992), for example, showed that auditors who were personally accountable for their decisions (opposed to those accountants “protected” by anonymity in an experimental setting) were less likely to issue a “clean” opinion.

<sup>141</sup> Despite the recent significant changes in the profession and organizational context of auditing, Suddaby et al. (2009: 409) find that “a majority of accounting professionals remain committed to their profession”. Yet, they have noted the strongest deviation between professional and organizational commitment especially “in the elite core of the profession”, in the Big 4 audit firms. Smith and Hall (2008: 75) argue that “public accountants may shift the focus of their commitment from an unstable work organization to the relative stability of their profession”. Professional commitment “has been linked to important outcomes such as improved work performance, reduced turnover intentions, and greater satisfaction at both the organizational and professional level” (Hall et al. 2005: 89). Higher professional commitment furthermore has been related to moral development (e.g., King 2002), ethical attitudes, such as rule observance attitudes (e.g., Shaub et al. 1993) and more appropriate decision-making (e.g., Jeffrey and Weatherholt 1996).

<sup>142</sup> Kosmala and Herrbach (2006), for example, argue that compliance pressure transforms professionals into “compliant” employees, who may not be inclined to challenge issues.

compliance behavior has also been associated to the recent audit failures, which would call for a back-to-basics revision of the audit approach.<sup>143</sup>

The rules versus principles distinction is also reflected in the standard audit approached that firms have implemented. These are based on the audit firms' interpretation of the international auditing standards.<sup>144</sup> Their methodologies are designed to assure compliance with the standards on the one hand, and to increase the efficiency of the audit process on the other.<sup>145</sup> Two distinct forms of audit firms are recognized based on their audit methodologies: structured and unstructured firms (e.g., Cushing and Loebbecke 1986; Wallage 1991; Bowrin 1998; Hyatt and Prawitt 2001). Structured firms are characterized by their more formalized organizational structure as well as by the structure of their audit methodology (e.g., Wallage 1991). The more structured firms tend to employ more prescribed audit methodologies focused on the consistency of the audit process (compared to less structured firms that are relatively more focused on the outcome and audit judgment). Kinney (1986) found that structured firms preferred more structured standards from the standards setters (i.e., "rules-based").<sup>146</sup>

Interesting in this respect is that Schroeder et al. (1989, quoted in Sorensen 1990) found that professional and organizational commitment (e.g., the soul and culture of the firm) is higher with audit partners and managers from unstructured firms, and lower with structured firms. "As an interpretation of these findings, [managers and partners] who are given greater autonomy [an important virtue to auditors personally]

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<sup>143</sup> Reinstein and McMillan (2004) showed that if auditors "had ethically applied [the auditing standards on fraud] the Enron debacle would likely never have happened". They conclude to argue that "the Enron debacle suggests that the profession should adopt more of a "back to basics" approach to auditing", meaning away from the overemphasis on the business risk audit model and more of substantive approach to testing. Indeed, Knechel (the designer of the business risk audit model) suggests (Knechel 2007) that "the aftermath of Enron (...) may provide a viable foundation for reconsidering business risk auditing".

<sup>144</sup> Audit technology is defined by Libby and Luft (1993) to include the whole apparatus of guidance and support that is made available to auditors with the purpose of aiding and controlling their judgment. Although audit approaches differ from firm to firm (e.g., Blokdiijk et al. 2006: 27), research on audit approaches has been done through two perspectives: that of structured versus unstructured approaches, and that of the technological perspective (e.g., electronic filing and other decision aids).

<sup>145</sup> Power (2003), however, argues that formalized and prescribed audit approaches function often more to legitimize individual and organizational behavior than to support efficient and rational decision-making, borrowing from Humphrey and Moizer 1990, who observed that "official guidance plays little role in everyday audit work, but rather it legitimizes work in the event of disputes with clients". Power furthermore argues that the audit has been split into two (or even three) audits: "one dealing with documentation and form filling (compliance with the traditional structured approach) and the other more risk-oriented, operated by higher level partners". A third form Power sees is "consulting being designed into the audit process itself" as can be seen in the audit planning process, which process is "a myth. (...) The boundaries between "audit planning" and "knowledge acquisition" as a basis for cross-selling other assurance and risk management advisory services is no longer a clear one" (2003: 384). Power concludes that "the audit process is permeated by hunch and intuition, despite projects to introduce more formal structure" (2003: 389).

<sup>146</sup> Dowling and Leech (2007) have also reported down-sides ("costs") of applying electronic audit systems, such as a potential over-reliance on recommendations made by the system, mechanistic behavior (i.e., emphasis on "ticking the box" over judgment) and limitations on use due to perceived complexity. These features can result in auditors not adopting a decision aid or misusing it.

are apparently more committed to the profession and to the firm providing a greater professional expression” (Sorensen 1990: 331). In other words, the more rules audit firms set and the less aligned the corporate values are with personal values, the less committed auditors are to take responsibility and ownership. This results, among other things, in auditors finding “mazes” to rationalize the socially “unacceptable” behavior “acceptable” irrespective of the (increased number of) rules.

#### ***2.5.4.2 Profession-related workplace stress***

Jelinek and Jelinek sketch how the current developments in the audit profession lead to increases in an auditor’s workload and, consequently, increases in workplace stress (2008: 224):

Public accounting has its share of highly stressed workers; it is among the most stressful professions (...). This is largely because a single Big 4 auditor serves a portfolio of clients, each of whom demand sage, expert advice and attention, and who want reports filed faster than the previous year and at a lower cost. In response, audit firms increasingly lean on their auditors to get more done in less time. For audit professionals, this means increased travel, unwanted overtime, and an overloaded schedule that demands they bounce from client to client. It also means that the busy season swallows up more and more of the calendar every year, which, in effect, cuts into personal time and increases the burden felt by the auditors’ families, which in turn ratchets up feelings of guilt and perpetuates even higher levels of stress.

The most significant part of their argument is that “while accountants at large firms have been facing stress for years<sup>147</sup>” Jelinek and Jelinek point to a number of societal and professional developments that are making the auditor’s job even more stressful. These “aggravators”, that would increase deviant workplace behavior, are (based on Jelinek and Jelinek 2008: 224-225):

- The Sarbanes-Oxley effect, creating additional workloads, specifically in relation to the requirement under Section 404 for an audit opinion on the client’s internal controls, next to the opinion on the financial statements<sup>148</sup>;
- The market effect, due to a shortage of and increased demand for talent. Some firms are beginning to acknowledge that market conditions may be spiraling out of control;

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<sup>147</sup> They even go so far as to refer to studies that show that auditors in the US suffer more headaches than any other professional and that in the UK the suicide rate among accountants is 10% higher than average. Nevertheless, Jelinek and Jelinek have a point in noting “workplace stress” as a factor impacting auditors’ behavior significantly – in this case they refer specifically to “deviant workplace behavior”, among which “cutting corners” (e.g. premature sign-off) and under-reporting of time.

<sup>148</sup> Jelinek and Jelinek (2008) report about 72% of US accountants responding that their jobs were becoming more stressful, leading 25% of respondents to report that they regretted their decision to enter the accounting profession.



- The public enemy effect, due to the “public distrust”, carried over from past accounting scandals.<sup>149</sup>

A fourth, more recent additional “aggravator” that I would add, can be found in the “credit crunch” and the economic downturn of 2008-2009. On the one hand, these lead to pressure on audit fees and a drop in those additional consulting services that are still allowed and, hence, pressure on revenues and profitability. Anecdotal evidence already shows that audits again are “bought” as an investment in a strategy of selling additional audit or consulting services in future; hence, effectively this is a return to the 1990s.<sup>150</sup> On the other hand, clients need more attention with the issues and challenges confronting them such as finance restructuring, cost reduction programs, reorganizations, impairment charges, and disposals.

A fifth “aggravator” can be seen in the increased importance of “interpersonal skills” and “emotional intelligence” which auditors are expected to develop (as referred to earlier in this chapter). For auditors, generally being inherently “data-oriented” (Istvan 1973), this may already be a stretch in itself. At the same time Barret et al. (2005) refer to this as well, “managing evidence and documentation is increasingly important” in these “compliance ages” (indicating indeed a need for data orientation). Hence, the two (to many opposite) behavioral traits are vying for attention and are, hence, leading to additional workplace stress.

## 2.5.5 Organizational contextual variables

Under the heading “organizational cultural factors” I cover those behavioral drivers that originate from or are connected to the auditor as part of the audit firm he or she works in. These factors comprise organizational image (e.g., Francis 2004: 345; Pierce and Sweeney 2005: 363)<sup>151</sup> and acculturation<sup>152</sup>; the employment relationship between

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<sup>149</sup> Following the debacles, such as Enron-Anderson, precipitous drops in the public’s perception of the entire profession were reported, leading to “widespread soul-searching among many auditors (...) fueled by what social psychologists call “cognitive dissonance”, or a feeling of discomfort resulting from performing an action that runs counter to one’s customary conception of “oneself” (Jelinek and Jelinek 2008: 228).

<sup>150</sup> Even in these times of auditor independence, or maybe just because of these economically tough times, a revival of the “commercial” auditor can be noticed. For example, in February 2010 Deloitte openly confessed to count on a constructive and valuable relationship as advisor after their loss of the financial audit of ABN Amro Bank to KPMG (and related fees of €32.5 million). Although understandable, the important point is that at that time Deloitte was still working on the finalization of the financial audit of ABN Amro Bank for 2009 (based on Van Wijnen 12 Februari 2010).

<sup>151</sup> Image management is important for audit firms (Power 2003) and “plays a key role in clan control by projecting a positive and carefully managed public image of the partnership both externally to the public and clients and internally to audit staff” (Pierce and Sweeney 2005: 363). Pierce and Sweeney even conclude that partners ignore the existence of, for example, dysfunctional behavior in order not to contaminate the good image or firm culture (2005: 363): “The absence of open discussion and explicit recognition of the risk of “quality threatening behaviors” appears to form part of internal and external image management”.

<sup>152</sup> Successful acculturation of employees influences an organization’s and an auditor’s performance (Jenkins et al. 2008: 48) and retention with the firm. Ponemon and Gabhart (1990) found that employees

the auditor and the audit firm and “personnel concepts” (e.g., Ferris 1981; Alvesson 2004; Almer et al. 2005; Smith and Hall 2008), including professional-organizational conflict (e.g., Bamber and Iyer 2002)<sup>153</sup>; management controls within a professional service firm; teamwork or “between-auditor interactions” (e.g., Almer et al. 2005; Pierce and Sweeney 2005: 364); a firm’s audit approach and technological development (e.g., Libby and Luft 1993; Bédard et al. 2006; Blokdijs et al. 2006; Dowling and Leech 2007; Bédard et al. 2008a; Dowling 2009); and the size and nature of the audit firm and business practice (e.g., Greenwood et al. 1990; Pratt and Beaulieu 1992; Reynolds and Francis 2000).

Behavioral drivers in the context of the organization that are considered specifically relevant and pervasive for the auditing context in relation to the subjective interpretation and application of the standards are:

- Audit firm’s management controls and socialization
- The business of auditing and the cost-quality dilemma.

These two drivers are discussed in more detail below.

#### ***2.5.5.1 Audit firm’s management controls and socialization***

“Partnerships differ from most other business firms because their form of ownership and governance is distinctive. (...). In a partnership, by contrast [to typical business firms where shareholders are usually outside the organization], ownership, management, and operations are fused” (Greenwood et al. 1990: 729-730).<sup>154</sup> Consequently, as seen in § 2.4.8.2 management of a professional partnership generally comes down to a number of “socialization themes”, such as clan controls, reinforcing common beliefs and values, and working with a strong client orientation.

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who fit well with a firm’s culture likely remain with the firm longer. Benke and Rhode (1984) support this by having shown that those who are of a poor fit either leave voluntarily or are not promoted by the firm.  
<sup>153</sup> Bamber and Iyer (2002), in their study of Big 4 public accountants, found job autonomy to increase both auditors’ professional and organizational identification and commitment, and to reduce organizational-professional conflict. This suggests that “job autonomy amplifies the professional attitude of an auditor, thus, decreasing undesirable behavior and the need to monitor” (Jenkins et al. 2008: 50).

<sup>154</sup> Greenwood et al. (1990: 730) paint a fairly clear picture of the traditional management structure of the partnership form of an international accounting organization: The structure’s dominant feature is that the [inter]national office of a firm, the formal equivalent of a corporate headquarters, is controlled through a form of representative democracy. At the strategic apex is a partnership body, which generally meets at least twice a year and which elects an executive policy committee. The executive policy committee, drawn from the ranks of the partnership, is typically constituted to represent major functional areas, such as audit and taxation, and major geographical areas. Other committees, called national committees, are similarly constituted and are concerned with both major functional areas and managerial functions such as professional development, professional standards, and marketing. The important point is that the structural vehicles of the national office are committees comprising partners drawn from the field, not, as in other business, individuals. These committees, moreover, are ultimately accountable to the full body of a partnership: individual partners thus figure at both the base and the apex of these organizations. The main positions in a Big 4 audit firm in descending order of rank are generally partner, (senior) manager, supervisor, senior accountant and junior or staff accountant. Partners assume the final responsibility for all work performed and share most directly in the financial profits or losses.

Firms employ such corporate socialization measures to manage the quality of professional services provided by employees, and to ensure compliance with firm-wide policies, initiatives, and goals (Covaleski et al. 1998).<sup>155</sup> Fogarty (1992: 130) refers to this as the socialization process in which individuals are molded by the organization to which they seek membership ('role acquisition').<sup>156</sup> Some state that socialization is increasingly difficult in today's assurance firms.<sup>157</sup> Lord and DeZoort (2001) distinguish two forms of social influence pressure:

- *Obedience pressure* or "tone at the top" (from commands made by superiors): "Tone at the top", throughout the ranks, is important because young professionals frequently model behaviors of more senior personnel in an attempt to ensure success (Jenkins et al. 2008: 53); and
- *Conformity pressure* or "peer pressure" (from examples set by peers): Being a member of an "elite" company may fuel social identity, image and self-esteem. But peer-pressure can also be a destabilizing force in professional behavior under "stiff internal competition" (Alvesson 2004: 197), where it may lead to intensive identity work and very active "symbolic labor" or tactical behavior.

Socialization, furthermore, has a pervasive influence over time and at different levels in an organization. Chow et al. (2002) and Hood and Koberg (1991) reported evidence of culture differences across rank.<sup>158</sup>

Other important management controls are formal counseling sessions and performance appraisals (e.g., Covaleski et al. 1998). Tan and Jamal (2006) point to reputation management in auditing context where preparers of work papers engage in strategic behavior as stylizing work papers and perception management to favor the outcome of the performance appraisal process. This can be an issue as partners and managers are shown not to be very well able to assess their subordinates' abilities (e.g., Kennedy and Peecher 1997; Messier Jr. et al. 2008). The performance appraisal process was traditionally considered to provide incentives for the preparer to manage his/her reputation in the eyes of the reviewer.

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<sup>155</sup> Suddaby et al. (2009: 411) paint a less positive picture of the socialization objective, by stating that "individual professionals are subject to a series of socialization practices" or "disciplinary techniques" designed to align professional and organizational goals and which constrain professional judgment – in a variety of more or less subtle ways.

<sup>156</sup> He identified three categories of acculturation techniques: coercive (i.e., economic, structural, and legitimization); mimetic (i.e., role modeling and mentoring), and; normative (i.e., professionalization).

<sup>157</sup> Sweeney and Pierce (2004: 805) put out a warning on the effectiveness of socialization controls: "Informal controls such as social controls are increasingly difficult to implement in the current audit environment due to the high level of staff turnover, lack of job continuity and the recruitment of qualified seniors who have trained in other firms and have thus missed at least some of the socialization that occurs during the training contract". For example, Covaleski et al. (1998) and Viator (2001) find that *informal* mentoring is common and largely effective, but that *formal* mentoring programs are largely ineffective and of short duration.

<sup>158</sup> Hood and Koberg (1991: 18), for example, showed that "partners [within the then Big 8] perceived the culture of their organization as significantly more innovative and supportive" compared to bureaucratic, and compared to the audit staff employees too.

More recently, it has been acknowledged that the “up-or-out” system that triggered this process seems to be replaced with an “out-or-up” principle, which poses new challenges. A common concept within auditing is the “up-or-out” principle: “If an individual is not promoted within the usual “window”, she or he is counseled to leave the firm. (...) While a significant proportion of the individuals who remain with the firm for five years make it to the managerial ranks, it is much more difficult to make it through the final “screen to partnership” (McNair 1991: 639). However, given the changing environment, Sweeney and Pierce (2004), find that traditional “up-or-out” strategy to have been replaced by an “out-or-up” policy, “with promotion occurring automatically for many of the auditors who remain in the firm”. Audit firms appear to have less choice regarding who gets promoted and, given the need to retain staff, the formal evaluation system is perceived by seniors as being less relevant in promotion decision than previously”. They point to the risk of “qualitative overload pressure” on audit staff as the result thereof, due to the “increased levels of responsibility assigned to audit juniors and seniors (...) that can result from individuals being promoted too quickly”.

#### ***2.5.5.2 The business of audit: a cost-quality dilemma***

Audit firms face an “inherent governance dilemma”; the constant conflict between the business of auditing<sup>159</sup> and the profession of auditing, or the “cost-quality dilemma” (McNair 1991). This conflict, in combination with the fact that audit quality, which is largely unobservable to the public, is difficult even for auditors themselves to measure (Power 1993) and poses a pressure for auditors to sacrifice audit quality in favor of reducing audit costs (McNair 1991: 637). And aggressive audit fee competition makes it difficult to charge these additional costs to their clients (Sweeney and Pierce 2004). The more traditional management or business controls in audit firms focus on chargeable hours (or market-financial targets) and tight (production) cost controls (such as time budget)<sup>160</sup>. Nowadays, such controls have become increasingly important.<sup>161</sup>

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<sup>159</sup> The “business of auditing” refers to the auditor’s ability to maximize the profitability of an individual audit or account (McNair 1991).

<sup>160</sup> A significant aspect of audit firm’s management controls is to exercise tight cost control without compromising quality standards (McNair 1991). Given that audit firms are labor intensive and audit quality is difficult to measure, formal cost control is exercised by using time budgets (Sweeney and Pierce 2006). Time budget achievement has been found to be one of the primary criteria for performance evaluation (Kelley and Seiler 1982). Two forms of time pressure are distinguished (Sweeney and Pierce 2004: 789): deadline pressure (pressure to have the work completed by a certain date) and budget pressure (pressure to control the number of hours charged to a job). Deadline pressure has been found to be more pervasive in its influence on auditors’ behavior.

<sup>161</sup> Financial targets were not overly dominant a couple of decades ago, on the then still much appreciated notion that “partnership implies a career commitment, which is inconsistent with financial myopia and tight accountability” (Greenwood et al. 1990: 736). Suddaby et al. (2009: 414) add that professional audit firms historically were generally “less demanding in terms of financial accountability (...) and have more strongly reinforced traditional professional norms and values than do corporate forms of organization”.<sup>161</sup> Tolerant accountability would have characterized professional partnerships because they were concerned with long-term measures of performance that are not strictly financial. Nowadays,

“Given the competitive nature of public accounting (...) auditors are inclined to be aggressive in the domain of practice development” (Cohen and Trompeter 1998).<sup>162</sup> This is mainly evident in the cross-selling behavior of auditors. Wyatt has illustrated the increased pressure on fees, sales and income during the 1980s telling (2004: 48):

The relative success of the consultants created enormous pressure on the auditing and tax practice, both to grow revenues and increase margins. The successes in the consulting practice increasingly influenced behavior by auditing and tax leaders, and the impact of these behavioral changes gradually affected the behavior patterns of audit and tax personnel as well. (...) Auditing was acknowledged by the 1980s to be a commodity service, even by many in the profession and, therefore, became subject to extreme fee pressure. (...) Top leadership within the firms gradually moved from those with outstanding technical accounting and auditing skills to those who were recognized as the preeminent ‘rainmakers’ within the organization. (...) There were no dramatic turning points, no particular events that one can point to and say, ‘This was the start of the downfall’.

While analyzing the culture change in accounting firms in the 1980s and 1990s, Wyatt concludes (2004: 50), “Cross-selling a range of consulting services to audit clients became one of the important criteria in the evaluation of audit partners. (...) Keeping the client happy and doing what was necessary to retain the client achieved a prominence”. Its impact on an auditor’s decision-making process is evidenced in several studies (e.g., Farmer et al. 1987; Falk et al. 1999; Nelson and Tan 2005)<sup>163</sup>. As Jenkins et al. state (2008: 46): “The Sarbanes-Oxley Act of 2002 and the demise of Arthur Andersen LLP serve as reminders of the consequences of fostering a culture that values revenue generation over quality service”.

With the sale of the consulting business by most of the Big 4 accounting firms and the ban on consulting services threatening audit firms’ independence triggered around the 2002 enactment of Sarbanes-Oxley legislation, for a number of years the

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further centralization of management controls has led to an emphasis on financial numbers rather than on professional values and quality. “The firms wish partners to become identifiable as a ‘realization rate’ or a ‘revenue stream’ so that the partner could be compared with peers, ranked, and thus pressured to comply with the norm” (1998: 310).

<sup>162</sup> Cohen and Trompeter (1998) have examined how audit managers’ judgments may be affected by the business of auditing and related practice development objectives. They find that the type of client (whether it is an existing client or a potential client to be gained) and the aggressiveness of the partner with respect to business development significantly (negatively) impacted the audit managers’ appropriate judgments on accounting treatments. They conclude that accountability is, therefore, important in the professional audit environment.

<sup>163</sup> Farmer et al. (1987) have found that auditors are more likely to require their client to change their accounting treatment when the risk of client loss is low. Falk et al. 1999 show that auditors’ conclusions about whether a qualified opinion was necessary were negatively correlated to the adverse consequences of issuing a qualified report (such as financial loss and loss of a client). And other studies have highlighted that “the balance of auditors” incentives for client retention versus audit quality affects not only their correction decisions given that a misstatement is detected, but also the audit planning decisions that determine whether a mis-statement is detected in the first place” (Nelson and Tan 2005).

audit firms took a step back towards what some would call the “right” professional direction (away from consulting services). However, with Sarbanes-Oxley becoming somewhat lenient and the pressure on fees for a commodity service continuing (or increasing with the credit crunch), the “cycle” is on his way “up” again. The recent upswing of “low-balling” practices internationally, is illustrative for the audit business environment hardening up, which will lead to increased pressure on fees and income and a push on firms to provide additional services. Or as Wyatt puts it sharply (2004: 51):

The firms (...) continue to expand the range of services offered within their auditing and tax divisions, compensating in part for the previous services that have had to be discontinued under the provisions of recent legislation. (...) However, the underlying causes of the decline in accounting professionalism remain in place.

With that Wyatt points to the behavioral change that needs to be realized, initially through the “tone at the top”. Suddaby et al. underlines this need by arguing that the *organizational* context and content of auditors’ professional work, as it has developed since the 1980s, is a possible explanation for the “erosion of *professional* values” (2009: 409). Sikka in response puts it even stronger by saying (2009a: 428-429): “Most accountants work in bureaucratic settings driven by commercial rather than professional logic. In pursuit of efficiency, standardization, predictability and market domination, the work of accountants is subjected to controls and could be said to be proletarianized”.

## 2.5.6 External interaction and environment

The behavioral drivers covered under the external interaction and environment are related to the interaction of the auditor with other actors and the environment *external* to the auditor, the audit firm, and the profession. The first and foremost external actor shaping auditors’ behavior is the client, including the audit committee (e.g., DeZoort et al. 2003b, 2003a, 2008). The interaction with the client brings about the trust and attachment dilemma<sup>164</sup> and information and power asymmetry<sup>165</sup>, or client capture

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<sup>164</sup> On the one hand auditors make considered investments in their client to be their trusted advisor (e.g., Fichman and Levinthal 1991). On the other hand those same relationships are important sources of information and audit evidence. With management as a pervasive source of information, this poses a “trust dilemma” (Kaplan et al. 2008). Kaplan et al. (2008) and showed that more experienced auditors are better able to deal with the persuasiveness of their clients and conclude that experience adds to an auditor’s *persuasive knowledge*, which allows them to stand up to management’s persuasion attempts (also see Anderson et al. 2004).

<sup>165</sup> On the one hand “the power asymmetry favors the professional owing to its knowledge and/or status in a specific area (knowledge-based position of superiority to the client)” (Alvesson 2004: 26). On the other hand “as the client is paying, there is frequently a financial asymmetry favoring the client and placing the [professional] in a subordinated position. (...) Paying high fees makes them feel entitled to demand efforts and sacrifice that they would not ask of their own personnel” (Alvesson 2004: 104).

(Suddaby et al. 2007).<sup>166</sup> Other “external actors” shaping auditors behavior are the interactions with society at large (e.g., public trust and reputation); the litigiousness of the business environment; and the competition among audit firms and the related fee pressures (see § 2.5.5.2). The interaction with society at large includes the socio-economic factors in the external environment of the auditor, such as the credit crunch or corporate failures.<sup>167</sup>

Behavioral drivers of the interaction interface that are considered specifically relevant and pervasive for the auditing context in relation to the subjective interpretation and application of the standards are:

- Public trust and reputation
- Litigiousness of the audit environment.

These two drivers are discussed in more detail below.

#### ***2.5.6.1 Public trust and reputation***

The interaction with “society at large” comes into play through the fundamental principles underlying the audit profession (e.g., the agency theory and the auditor’s responsibility towards a variety of third parties in general. As such it mainly impacts auditors’ behavior in an indirect way. In particular, an audit firm’s reputation, and more generally the “public trust”<sup>168</sup> in the profession as a whole, is affected by the perception society at large has of the audit profession and the audit quality they are perceived to provide, as seen in the last decade.<sup>169</sup> The importance of public trust and reputation is well illustrated in the Arthur Andersen case. “The day Arthur Andersen loses the public’s trust is the day we are out of business” said Steve Samek, Country Managing Partner USA for Arthur Andersen in 1999 (quoted by Pflugrath et al. 2007). This prediction turned out to be true with the Enron collapse.

It is in these crises and failures that the interaction with “society at large” has the most significant or direct impact on the auditors. For example, Sarbanes-Oxley and

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<sup>166</sup> The salience of the information asymmetry in auditing is that auditors in essence have no incentive to close the “expectation gap” by being more transparent about what they do and how they do it. Sunder (2002) notes, for example, that “interactions between the auditor and important stakeholders are likely to be strategic in nature – each party has a particular set of interests”.

<sup>167</sup> Other environmental and socio-economic factors that may have an impact in the audit profession are, for example, the legislative environment, economic status, maturity of the profession, and labor market effects.

<sup>168</sup> Trust as such is an essential, yet sensitive issue. “The market is a very imperfect evaluator and clients have mixed feelings about the [professionals] they are getting services and products from. More broadly, there is often considerable distrust, skepticism, or at least the absence of full confirmation of the professional’s claim to having a superior and effectively problem-solving knowledge base. (...) We find two common opinions about consultancy work: it is not “real” and it is overpaid” (Alvesson 2004: 198). This theme is closely related to what I call in this study “perceived” quality or performance. Jelinek and Jelinek (2008) refer to “*public disgust*” as the result of the financial debacles at the start of this century.

<sup>169</sup> “Recent high-profile corporate collapses, such as Enron and WorldCom, have brought into question the status and credibility of the accounting profession, especially auditors, with allegation of accountants’ violations of public trust” (Pflugrath et al. 2007).

similar legislations in many other countries, with significant impact on the position and responsibilities of the auditor, were enacted in response to the audit failures around the Enron-Anderson case and in effect led to the profession's loss of self-regulation. The "credit crunch" and the current financial crisis is another example where increased (or at least changed) societal expectations of the auditing profession have an impact. As such, these societal "equilibrium changes" result in an ongoing discussion around the expectation gap, i.e., significant differences between what the public expects from an audit and what the assurance professional perceives the objectives to be and how he/she interprets and applies them.

Hence, reputation is one of the most important existential factors for the Big 4 accounting firms. It brings about competitive advantages and barriers for others, "in that clients will only consider and select from a limited set of firms with a good reputation" (Alvesson 2004: 73), hence the Big 4 accounting organizations. Greenwood et al. point to three reputation benefits for audit firms (2005: 663): "the ability to hire the very best students; lower marketing costs because clients actively seek high-status firms; and the ability to charge premiums because of their brand name". They close to say that these benefits, however, constitute a sensitive vicious cycle. Weber et al. (2008) supported this "reputation rationale" for audit quality by illustrating the negative effects on KPMG Germany's client portfolio after the widely publicized (and thus reputation damaging) 2002 ComROAD AG accounting scandal ("97% of the calendar year 2000 revenues were fictitious").

Professional reputation is closely related to perceived audit quality, where clients associate reputation to a perceived credible commitment to high quality. For example, Chaney and Philipich (2002) show that stock markets are sensitive to the reputation of the auditor of the companies they invest in.<sup>170</sup> This perception subsequently leads to a willingness to pay a premium ("quasi-rents") (e.g., Weber et al. 2008). This is also related to the "insurance/liability theory" (Watts and Zimmerman 1983) that rationalizes that an audit firm's reputation serves as a bond for audit quality. Because larger firms tend to be wealthier (i.e. they have "deep pockets") they have greater incentive to provide high-quality audits. DeAngelo (1981b: 185) argues that larger, reputable audit firms have "more to lose" by providing low-quality audit services.<sup>171</sup>

### 2.5.6.2 *Litigiousness of the audit environment*

Prior research "suggests that auditor performance is sensitive to changes in legal liability" (Carcello 2005: 32). A number of studies show how litigation risk impacts the behavior of auditors. Farmer et al. (1987) have found that auditors are more likely to require their client to change their accounting treatment when the risk of litigation is high. Khurana and Raman (2004), in a cross-sectional study of Big 4 versus non-Big 4

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<sup>170</sup> "On the three days following Andersen's admission that a significant number of documents had been shredded (10 January 2002), we find that Andersen's other clients experienced a statistically negative market reaction, suggesting that investors downgraded the quality of the audits performed by Andersen" (Chaney and Philipich 2002).

<sup>171</sup> Indeed, Reynolds and Francis (2000) found that auditors report more conservatively for larger clients (i.e., higher monetary risk), "suggesting that reputation protection dominates auditor behavior".



firms, suggest that it is litigation exposure rather than protecting the brand name that drives perceived audit quality.

De Fond and Francis openly question whether the current litigiousness of the environment is not too “brutal” for health reasons (2005: 6):

[I]t is an open question whether we need the kind of extreme litigation exposure we currently have in the U.S. in order to achieve an appropriate level of audit quality. We observe that countries such as Canada and Australia appear to have credible auditing without imposing such a brutally litigious environment.

Pierce and Sweeney (2005: 342) observe how this can turn the scale: “Risk of litigation now tends to arise more from a failure to ensure audit processes are carried out rather than a concern with client documents”. Weber et al. (2008) point to a long-lasting professional discussion related to “capping” auditors maximum liability in litigation, which, for example, has existed in Germany since 1931. These features would lead to what is considered a healthier and balanced accountability pressure on auditors.<sup>172</sup>

## 2.6 Summary and conclusion

Given the relevance of behavior in general and to the assurance profession in particular, the research question central in this chapter is:

- What is professional behavior in general and that of auditors in particular, what drives professional behavior, and how does culture play a role in this context?

Based on the study of definitions and fundamental theories, the definition of professional behavior used in this study is based on the notion that professional behavior is:

- driven by one’s human nature and personal needs, motivations, ethics, and psychological cognitions and limitations;
- guided and controlled by internalized values and beliefs that are shaped by personalized interpretations of national, professional, and organizational cultures, conventions, and norms;
- conditioned by the external constraints and situational contingencies from discretionary interactions with external actors and the profession’s immediate business environment;
- leading to “actions”, being the actual professional behaviors visible to the outside world, and a certain “end result” or performance.

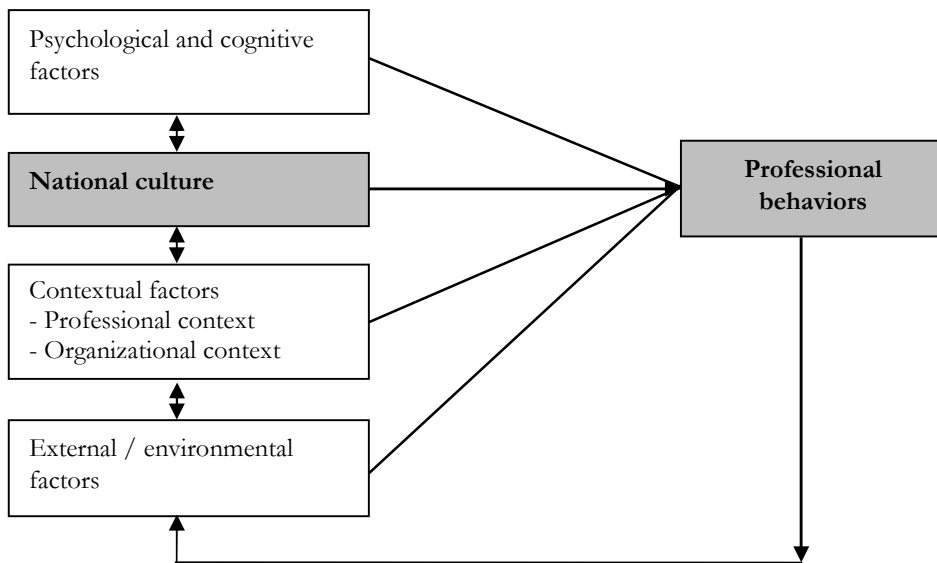
Auditors’ professional behaviors identified in this study and the basis for the empirical phases of this study, comprise the following:

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<sup>172</sup> Weber et al. (2008) still find support for the reputation rationale in Germany.

- Judgment and decision-making
- Skeptical judgments and decisions
- Knowledge sharing and consultation behavior
- Working in fluid teams (engagement partner involvement)
- Communication and negotiation behavior on observations and findings
- Documentation and justification
- Dysfunctional behaviors
- Audit pricing and practice development

Based on this definition and the behavioral conceptualizations covered in Chapter 2, these professional behaviors are visualized in the context of its drivers in the following proposed conceptual framework of drivers of professional behavior (a detailed overview is included in Appendix 1):



*Figure 1 – The effect of national culture in the context of the drivers of professional behavior*

The relative effect of national culture in the context of the professional behavior of auditors is the focus of this study, as illustrated in § 1.3. National cultural differences and their impact on behavior in general are covered in the next chapter.

